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94-2030

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

MARK V. HARKINS, SULLIVAN & LONG, INC., JOSEPH D. LAPOTA, JR., SAMUEL HOOKER, CHARLES HAWKER, CAROLE BLAND, AUDREY HEWITT, ANTHONY HEWITT, JOHN ECKENSTEN, RONALD J. MORAN, LESLEY RANNEY MORAN, TIMOTHY J. MORAN, LEON D. ARDELEAN, JEFFREY J. SIMS, SHEFFIELD WOLK, A. J. BLYTHE, DOROTHY B. NUSSDORF, DAN CHLIPALA, and JAMES HAMBURGER,

Petitioners,

v.

SCATTERED CORPORATION,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Do the securities laws' prohibitions on market manipulation exempt deliberate manipulative acts which move a stock price towards a perceived "true economic value"?

2. Can a market maker who short sells vastly more shares of a company than actually exist, be considered an "issuer" subject to liability under § 12(1) of the Securities Act of 1933, 15 U.S.C. § 771(1), for selling securities without a registration statement, in violation of Securities Act § 5, 15 U.S.C. § 77e?

LIST OF PARTIES

The plaintiffs to the proceedings below, all of whom are petitioners here, were Mark V. Harkins, Sullivan & Long, Inc., Joseph D. LaPota, Jr., Samuel Hooker, Charles Hawker, Carole Bland, Audrey Hewitt, Anthony Hewitt, John Eckensten, Ronald J. Moran, Lesley Ranney Moran, Timothy J. Moran, Leon D. Ardelean, Jeffrey J. Sims, Sheffield Wolk, A.J. Blythe, Dorothy B. Nussdorf, Dan Chlipala, and James Hamburger, all individually and as representatives of the certified class. Scattered Corporation, defendant below, is the respondent before this Court.

No petitioner has any parent or subsidiary company.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
LIST OF PARTIES	ii
TABLE OF AUTHORITIES	v
OPINIONS BELOW	1
JURISDICTION	2
STATUTORY PROVISIONS INVOLVED	2
STATEMENT OF THE CASE	4
A. Factual Background	5
B. The Litigation	8
REASONS FOR GRANTING THE WRIT	9
I. THE SEVENTH CIRCUIT'S ADOPTION OF AN EXCEPTION FOR "GOOD" MANIPULATION HAS NO LEGAL BASIS, CONFLICTS WITH OTHER CIRCUITS' DECISIONS THAT PROHIBIT MANIPULATION REGARDLESS OF DIRECTION, AND EVISCERATES THE PROTECTIONS AGAINST MARKET MANIPULATION	9
A. Actionable Manipulation Is a Major Issue in Current Securities Law	9
B. Creating a "Good Manipulation" Exception Within the Seventh Circuit Clashes with Established Law by This Court and Other Circuit Courts Enforcing Liability for Manipulation Regardless of Its Direction	10
C. The "Good Manipulation" Exception Conflicts With Other Circuits' Case Law	10

TABLE OF CONTENTS—Continued

Page

D. A "Good Manipulation" Exception Is Untenable, Unworkable, and Abhorrent to the Concept of Free and Open Markets 11

E. The Manipulative Devices at Issue Here Have Been Recognized As Violating § 9(a)(2) of the Securities Exchange Act of 1934, Without Regard to the Direction of the Manipulation.. 11

F. A "Good Manipulation" Exception Is Difficult, If Not Impossible, to Apply 13

II. THE SEVENTH CIRCUIT'S LIMITATION OF ISSUER LIABILITY TO CONVENTIONAL ISSUERS ALSO CREATES A CONFLICT WITH OTHER CIRCUITS OVER WHO MAY BE LIABLE AS AN ISSUER, AND IMPROPERLY RESTRICTS THE SCOPE OF LIABILITY FOR ENGAGING IN UNREGISTERED OFFERINGS OR SELLING UNREGISTERED SECURITIES 14

CONCLUSION 16

TABLE OF AUTHORITIES

CASES — Page

Basic Inc. v. Levinson, 485 U.S. 224 (1988) 11
Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970) 12
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) .. 10
Gustafson v. Alloyd Co., Inc., 115 S.Ct. 1061 (1995) 14
Pagel, Inc. v. Securities and Exchange Commission, 804 F.2d 942 (8th Cir. 1986) 10
Pinter v. Dahl, 486 U.S. 622 (1988) 14
Rooney Pace, Inc. v. Reid, 605 F. Supp. 158 (S.D.N.Y. 1985) 12
Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) 10
Seagoing Uniform Corporation v. Texaco, Inc., 705 F. Supp. 918 (S.D.N.Y. 1989) 12
Securities and Exchange Commission v. Chinese Consolidated Benevolent Association, Inc., 120 F.2d 738 (2d Cir.), *cert. denied*, 314 U.S. 618 (1941) 15, 16
Securities and Exchange Commission v. Murphy, 626 F.2d 633 (9th Cir. 1980) 16
Trane Co. v. O'Connor Securities, 561 F. Supp. 301 (S.D.N.Y. 1983) 12
United States v. Charnay, 537 F.2d 341 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976) 10
United States v. Stein, 456 F.2d 844 (2d Cir.), *cert. denied*, 408 U.S. 922 (1972) 12

STATUTES

15 U.S.C. § 77b(4) 15
15 U.S.C. § 77d(1) 14, 16
15 U.S.C. § 77e 14
15 U.S.C. § 77*l*(1) 14, 15, 16
15 U.S.C. § 78i(a)(2) 11, 12

OTHER AUTHORITIES

Chicago Stock Exchange Article VII, Rule 5 ..... 5, 6
Chicago Stock Exchange Article VIII, Rules 1, 3 and 4 5

TABLE OF AUTHORITIES—Continued

Page

D. Fischel and D. Ross, *Should the Law Prohibit "Manipulation" in Financial Markets?*, 105 Harv. L. Rev. 503 (1991) 9

McLucas and Angiotti, 22 Review of Securities & Commodities Regulation, No. 10 at 104 (May 24, 1989) 11

New York Stock Exchange Rule 440F 5, 8

Securities Act Release Number 5223, Adoption of Rule 144, 1972 Fed. Sec. L. Rep. (CCH) ¶ 78,487 (1972) 16

Senate Comm. on Banking & Currency, Stock Exchange Practices, S. Rep. No. 1455, 73d Cong., 2d Sess. 54 (1934) 12

S. Thel, *$850,000 in Six Minutes—The Mechanics of Securities Manipulation*, 79 Cornell L. Rev. 219 (1994) 10

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PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

Petitioners respectfully request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit.

The February 8, 1995 opinion of the Court of Appeals is reprinted in the Appendices ("Pet. App.") at 1a. The opinion is reported at 47 F.3d 857 (7th Cir. 1995). The Court of Appeals' March 13, 1995 Order denying rehearing and rehearing *en banc* is reprinted at Pet. App. 32a.

The January 10, 1994 Memorandum Opinion and Order of the District Court is reported at 844 F.Supp. 416 (N.D. Ill. 1994) and reprinted at Pet. App. 18a, and

the District Court's March 29, 1994 oral ruling is unreported and reprinted at Pet. App. 28a.

JURISDICTION

On February 8, 1995, the Seventh Circuit Court of Appeals entered a judgment and opinion affirming the case dismissal, and a timely petition for rehearing with suggestion for rehearing *en banc* was denied on March 13, 1995.

This Court's jurisdiction to review the judgment of the Court of Appeals is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This Petition involves the following United States statutes:

1. 15 U.S.C. § 77b(4)

   Definitions

   When used in this subchapter, unless the context otherwise requires . . . (4) The term "issuer" means every person who issues or proposes to issue any security . . .

2. 15 U.S.C. § 77d(1)

   Exempted transactions

   The provisions of section 77e shall not apply to—(1) transactions by any person other than an issuer, underwriter, or dealer.

3. 15 U.S.C. § 77e. *Prohibitions relating to interstate commerce and the mails*

   Sale or delivery after sale of unregistered securities

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

Necessity of prospectus meeting requirements of section 77j of this title

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

Necessity of filing registration statement

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

4. 15 U.S.C. § 77l(1)

Civil liabilities arising in connection with prospectuses and communications

Any person who—

(1) offers or sells a security in violation of Section 77e of this title . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

5. 15 U.S.C. § 78i(a)(2)

Manipulation of security prices
Transactions relating to purchase or sale of security

(a) It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange—

(2) To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

STATEMENT OF THE CASE

Petitioners seek review of the Court of Appeals' decision affirming the dismissal of their consolidated class complaints alleging respondent's violations of the federal securities laws, *inter alia*, by short selling massive quantities of stock on trading tickets that were intentionally mismarked in order to conceal the true position and evade the applicable delivery requirements.

The District Court dismissed the complaint, *In re: Scattered Corporation Securities Litigation,* 844 F. Supp. 416 (N.D. Ill. 1994), in the view that respondent had injected accurate information into the marketplace and had done nothing wrong. Pet. App. 18a and 28a.

The Court of Appeals affirmed, *Sullivan & Long, Inc. v. Scattered Corp.,* 47 F.3d 857 (7th Cir. 1995), holding that movement of price towards a "true economic value" is not actionable market manipulation, and that a short seller market maker cannot be an issuer even if it short sells more than the total number of a corporation's outstanding shares. Pet. App. 1a.

A. Factual Background.

In early 1993, LTV Corporation, one of the country's largest steel makers, had been in bankruptcy for a number of years. At the time, LTV had 122 million issued and outstanding shares of common stock, which traded at about 62¢ a share. On February 26, 1993, LTV announced a plan of reorganization which, if approved, would convert all of its existing common shares into warrants to purchase new stock in the reorganized company, most of whose stock would be owned by former creditors. The reorganization plan estimated that the old stock would have an ultimate value of 3-4¢ a share.

Anticipating the bankruptcy court's May 27, 1993 approval of the reorganization plan, Scattered devised a short selling scheme of enormous size. Scattered saw the reorganization plan as an opportunity to wildly profit from manipulating the market for LTV stock by short-selling vast amounts of LTV shares in violation of applicable trading rules [1] and applicable five-day delivery obligations. Scattered's short-selling plan was done in a manner intended to cap the share price and maneuver it on a slow and steady decline, while delaying delivery of the shares, until the shares had been converted into the

[1] New York Stock Exchange Rule 440F; Chicago Stock Exchange Article VII, Rule 5, and Article VIII, Rules 1, 3 and 4.

nearly valueless warrants. Similar to the comedy movie "The Producers" [2], Scattered short-sold a huge number of LTV shares—far more than ever existed—mislabeled (on the trading tickets) as "short exempt".[3] By mismarking the trades "short-exempt", Scattered was able to evade its delivery obligations until the shares had been converted to warrants—long after the required trade settlement date. Deliberately mislabeling the trades as "short exempt" also furthered the scheme by avoiding the five-day delivery requirement and cleverly concealing Scattered's "short overhang" position from being publicly known and incorporated into the LTV shares' market price. This mislabeling was an integral part of the scheme, since public knowledge of a "short overhang" vastly exceeding the number of outstanding shares would have driven up the LTV share price and broken the scheme in its early stages.[4]

Scattered's scheme divorced the market from normal forces of supply and demand in two significant aspects. In addition to hiding the short position from detection,

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[2] In "The Producers", two schemers, has-been Broadway impresario Max Bialystock (played by Zero Mostel), and his quiet accountant Leo Bloom (played by Gene Wilder), raise money to produce a Broadway play by selling investors over 3000% shares of a play, and select and cast a play that would surely flop, intending to pocket the money raised from the investors, who will not look for their money back on a failure. The scheme unravels when the play, "Springtime for Hitler", becomes a hit farce, and the producers go to jail for their fraud.

[3] The "short-exempt" designation on a trading ticket means that the trade qualifies for an exemption from the usual five-day delivery requirements because the trade involves legitimate arbitrage or is necessary to maintain an orderly market. Scattered's LTV trades did not qualify for any such exemption. See Article VII, Rule 5 of the Chicago Stock Exchange.

[4] Because nonexempt short sales and short positions are routinely reported in the market, Scattered's short sales would have been reported, and its true massive short position disclosed and factored into the market price, if Scattered properly marked its tickets "short" rather than the misleading "short exempt" designation.

Scattered also timed its short selling to cap the LTV share price; that is, to prevent a rise which could have defeated the scheme. To maximize its profits from the scheme, Scattered also needed to keep the share price slowly and smoothly drifting continually lower, thereby producing higher revenues from the short sales.[5]

Scattered needed to cap prices to prevent any price upswing that would force it to "buy-in" (i.e., purchase replacement shares on the open market) the stock to cover any losses. Had Scattered *not* manipulated the market, and if it had to acquire shares for delivery within the prescribed five-day period,[6] the demand created by the purchases to cover the huge short positions would have naturally caused the share price to rise.

Such an upswing would have broken the scheme and financially ruined Scattered, which at the beginning of its scheme had insufficient capital to withstand any adverse price move.[7] In that event the Midwest Clearing Corporation—the stock clearing corporation of the Chicago Stock Exchange (formerly the Midwest Stock Exchange), where Scattered was a market maker and where many of the trades occurred—would have had to step in and guarantee Scattered's losses.[8] Scattered's short position eventually became so large that it exceeded the entire capacity of the Chicago Stock Exchange to cover the short position.

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[5] A sudden price drop would greatly diminish or end the revenue stream.

[6] Although not effective at the time, the recently announced "T+3" provisions would have required settlement within only three business days.

[7] With only approximately $1.5 million in capital in January 1993, Scattered would have been unable to meet its obligations to deliver the amount of LTV shares it sold short very early in the scam.

[8] Scattered actually put the liquidity of the Chicago Exchange and its clearing corporation at substantial risk. After Scattered

The scheme worked fabulously well for Scattered. The LTV stock's manipulated price crept gradually and steadily downward from just over 62¢ per share at the announcement of the reorganization plan to 7.8¢ per share on its last trade on June 29, 1993, the last day it traded. In total, Scattered's LTV trading produced it a profit of some $25 million.

B. The Litigation.

Several LTV stock purchasers[9] sued Scattered, alleging securities fraud, market manipulation, engaging in an offering of securities, in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934, plus violation of the federal RICO statute, and state law securities fraud, consumer fraud, and unjust enrichment.[10]

The trial court certified a class but dismissed the plaintiffs' initial consolidated complaint—on a F.R.C.P. 12 (b)(6) motion without any evidentiary submissions—on the trial court's belief that Scattered's trading was not actionable and that Scattered had done nothing wrong but had merely profited from injecting accurate information into the marketplace. Pet. App. 18a. Although plaintiffs amended their complaint by adding additional facts about Scattered's scheme and its effect on the plaintiffs and the class, the trial court again dismissed their

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was told to produce shares to cover purchases, Scattered's attorney, in a June 23, 1993, letter, responded by rebuking the demand with the threat that a forced buy-in would cause an uncontrollable and devastating price rise, saying "the resulting liability would be immense and could conceivably threaten the liquidity of both the Midwest Clearing Corporation and the Exchange itself."

[9] Most of the petitioners are individual public investors, although petitioner Sullivan & Long, Inc. is itself a market maker adversely affected by Scattered's scheme.

[10] Plaintiffs also alleged that Scattered violated stock exchange rules regulating short sales, such as New York Stock Exchange Rule 440F ("short exempt" sales are excluded from reporting on Form SS20 and are included in total sales only).

claims on the same grounds, without receiving any evidence, Pet. App. 28a, and plaintiffs appealed.

The Seventh Circuit Court of Appeals affirmed the dismissal. *Sullivan & Long, Inc. v. Scattered Corporation*, 47 F.3d 857 (7th Cir. 1995). In doing so, the Court of Appeals found that Scattered's manipulation was not actionable because it was done to move the price of the old LTV shares towards their "true economic value" of 3-4¢. Additionally, the Appellate Court held that a single short seller market maker such as Scattered cannot be an "issuer" under the securities laws, regardless of how many shares it sells, even if that number far exceeds the total number of outstanding shares.

REASONS FOR GRANTING THE WRIT

I. THE SEVENTH CIRCUIT'S ADOPTION OF AN EXCEPTION FOR "GOOD" MANIPULATION HAS NO LEGAL BASIS, CONFLICTS WITH OTHER CIRCUITS' DECISIONS THAT PROHIBIT MANIPULATION REGARDLESS OF DIRECTION, AND EVISCERATES THE PROTECTIONS AGAINST MARKET MANIPULATION.

By exculpating manipulative acts that move price in the direction of a court's view of a stock's future "true economic value," the Court of Appeals' decision creates a new "good manipulation" exception to established market manipulation law. This Court's review is called for in light of the serious question raised by this exception—whether manipulative conduct is exempt if it moves the market in an economically desired direction.

A. Actionable Manipulation Is a Major Issue in Current Securities Law.

The subject of actionable market manipulation has generated increasing debate, with some scholars now asserting that manipulation is either not possible or not a problem, and arguing that the entire concept of manipulation liability should be abandoned entirely. *See* D. Fischel and D. Ross, *Should the Law Prohibit "Manipula-*

tion" in Financial Markets?, 105 Harv. L. Rev. 503 (1991). Other scholars insist that manipulation remains a viable concept, and they have stressed the need for continued prohibitions against manipulative tactics. *See* S. Thel, *$850,000 in Six Minutes—The Mechanics of Securities Manipulation*, 79 Cornell L. Rev. 219 (1994).

B. Creating a "Good Manipulation" Exception Within the Seventh Circuit Clashes with Established Law by This Court and Other Circuit Courts Enforcing Liability for Manipulation Regardless of Its Direction.

No prior decision has ever exonerated an otherwise illegal price manipulation on the ground that the activities moved the share price in a specific direction which was the "good" or "right" direction. All previous decisions that address manipulation liability do not consider the direction of the price movement at all. This Court's holdings that market manipulation refers to practices that artificially affect market activity, *Santa Fe Industries, Inc. v. Green*, 430 462, 476-77 (1977), and that a person manipulates the securities markets by conduct willfully controlling or artifically affecting the price of securities, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976), never consider the direction of the manipulation [11] to be significant, let alone hold that the direction can be dispositive on the liability question.

C. The "Good Manipulation" Exception Conflicts With Other Circuits' Case Law.

The new exception created by the Seventh Circuit conflicts with other circuits, *see Pagel, Inc. v. Securities and Exchange Commission*, 803 F.2d 942 (8th Cir. 1986) (scheme to dramatically increase price despite lack of demand for stock), and *United States v. Charnay*, 537 F.2d 341 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976) (scheme to depress price in order to deceive company's

[11] I.e., whether the conduct manipulates the price of the security in an economically desirable direction.

shareholders and directors in connection with take-over attempt), which have not found the direction of the price manipulation to be determinative—or even relevant—to the question of liability for manipulation.

D. A "Good Manipulation" Exception Is Untenable, Unworkable, and Abhorrent to the Concept of Free and Open Markets.

All manipulation can be presumed to move price in a direction that benefits the manipulator and harms those investors taking opposite positions, believing that they are investing in a market whose prices are not rigged.

All market participants have a right to expect that prices are not being controlled, and therefore, the new exception announced below confounds the expectations of the investing public. Even if prices are being controlled in a "good", i.e., economically efficient direction, investors will hesitate to enter the market, for as this Court stated in *Basic Inc. v. Levinson*, 485 U.S. 224, 246-47 (1988), "it is hard to imagine that there is ever a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?"

E. The Manipulative Devices at Issue Here Have Been Recognized As Violating § 9(a)(2) of the Securities Exchange Act of 1934, Without Regard to the Direction of the Manipulation.

The decision below also disturbingly erodes the viability of § 9(a)(2) of the Exchange Act, 15 U.S.C. § 78i(a)(2), one of the two sections of the Exchange Act under which the vast majority of manipulation cases are brought, see McLucas and Angiotti, *22 Review of Securities & Commodities Regulation*, No. 10 at 104 (May 24, 1989), and conflicts with the other circuits that have addressed market manipulation under Section 9(a)(2).

Section 9(a)(2) outlaws:

> . . . a series of transactions in any security registered on a national securities exchange creating actual or

> apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

Section 9(a)(2) has been described as the "very heart of the [A]ct." *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 794 (2d Cir. 1989), *cert. denied*, 400 U.S. 822 (1970). Its objective is to ban "device[s] used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage." Senate Comm. on Banking & Currency, Stock Exchange Practices, S. Rep. No. 1455, 73d Cong., 2d Sess. 54 (1934). In enacting § 9(a)(2), Congress sought to protect investors, like members of the class here, "by maintaining a market controlled by natural forces rather than by intervention of artificial manipulative devices. . . ." *Trane Co. v. O'Connor Securities*, 561 F. Supp. 301, 305 (S.D.N.Y. 1983).

Scattered's mode of conduct has uniformly been held by the courts to constitute market manpulation under § 9(a)(2) in cases involving schemes analogous to the one here, without respect to the direction of the manipulation. *See Seagoing Uniform Corporation v. Texaco, Inc.*, 705 F. Supp. 918 (S.D.N.Y. 1989) (court upheld plaintiff's § 9(a)(2) claim where complaint alleged defendants' involvement in scheme to drive up price of stock through large purchases and incomplete disclosure, thus enabling defendants to effect quick sale of their stock at premium over artificially inflated market price); *Rooney Pace, Inc. v. Reid*, 605 F. Supp. 158 (S.D.N.Y. 1985) (plaintiff's claim under § 9(a)(2) sustained where plaintiff alleged that defendants effected series of orders to purchase stock while concealing their intention not to pay for stock or to condition payment on increase in price of stock); *United States v. Stein*, 456 F.2d 844, 850 (2d Cir.), *cert. denied*, 408 U.S. 922 (1972) (where activity in stock that public saw was "mirage" rather than reflection of genuine demand, court held: "This was manipulation [under § 9(a)(2)]."); *Crane Co. v. Washinghouse*

Air Brake Co., 419 F.2d 787, 795 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970) ("When a person who has a 'substantial, direct pecuniary interest in the success of a proposed offering takes active steps to effect a rise in the market' in the security, we think that a finding of manipulative purpose is prima facie established.").

F. A "Good Manipulation" Exception Is Difficult, If Not Impossible, to Apply.

The difficulty of application of the new exception is another reason for granting certiorari to review the exception. In considering whether the securities markets can be "rigged" in an appropriate direction, the lower courts will need to determine the "true economic value" of a security at a future given day or period. This would be no small task, as this case demonstrates. In the decision below, the Seventh Circuit declared, without benefit of evidence, a "true economic value" of 3-4¢ for LTV shares during the period from approval of the bankruptcy reorganization plan through the last day of trading, *see Scattered Corp.*, 47 F.3d at 862—even though during the period the share price was much higher, and on the last day of trading, the market set a price of 7.8¢ for an old LTV share.[12] In affirming the dismissal of the case, the Seventh Circuit felt it unnecessary to receive evidentiary submissions on the question of the "true economic value" of the shares—although the market, which is arguably the best judge of economic value, offered a value (price) different from that derived by the Court of Appeals.

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[12] That price probably would have been much higher if Scattered had had to cover the short sales.

II. THE SEVENTH CIRCUIT'S LIMITATION OF ISSUER LIABILITY TO CONVENTIONAL ISSUERS ALSO CREATES A CONFLICT WITH OTHER CIRCUITS OVER WHO MAY BE LIABLE AS AN ISSUER, AND IMPROPERLY RESTRICTS THE SCOPE OF LIABILITY FOR ENGAGING IN UNREGISTERED OFFERINGS OR SELLING UNREGISTERED SECURITIES.

In *Pinter v. Dahl*, 486 U.S. 622 (1988), this Court held that a broker or other person who solicits a purchase of securities could be a "seller" within the meaning of § 12(1).[13] Only this term, in *Gustafson v. Alloyd Co.*, 115 S.Ct. 1061 (1995), the Court ruled that Sec. 12(2) erroneous prospectus liability does not arise from private sales. That leaves open the question whether Sec. 12(1) liability still arises from unconventional public sales. The present case, involving respondent's sale of more than the entire outstanding LTV stock, again calls for granting certiorari to consider § 12(1) question: whether Sec. 12(1) liability extends to a market maker who engages in such a large public short sale volume that it has become an issuer or underwriter, whether for the entire volume, or just the volume in excess of the existing shares.

The gist of petitioners' § 12(1) claim is that Scattered engaged in an unregistered offering and became an issuer: by entering into vast naked short sales, Scattered expanded

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[13] Section 12(1) of the Securities Act, under which plaintiffs and the class seek rescission of their trades, provides that: "Any person who (1) offers or sells a security in violation of section 5 [15 U.S.C. § 77e] . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." 15 U.S.C. § 77*l*(1). However, section 4(1) provides that the section 5 registration requirements do not apply to "transactions by any person other than an issuer, underwriter, or dealer." 15 U.S.C. § 77d(1).

the amount of LTV stock outstanding but did not comply with the registration provisions of the 1933 Act.[14]

The Court of Appeals declared Scattered free of § 12 (1) issuer liability because it was not the issuing corporation, its controlling person, or a conventional underwriter. While legally "only LTV could issue LTV stock" and "persons controlling LTV, as well as (conventional) underwriters, could also be liable for selling unregistered stock", *Scattered Corp.*, 47 F.3d at 865, the mere fact that Scattered was—in the conventional sense—none of these, does not end the § 12(1) inquiry.

Section 2(4) of the Securities Act defines "issuer" generally as "every person who issues or proposes to issue any security". 15 U.S.C. § 77b(4). Scattered became an "issuer" of LTV stock by exercising complete control over the supply of that security. In contrast to the Seventh Circuit's decision, both the Second and Ninth Circuits have held that any person who participates in a securities distribution can violate the registration requirements of the Securities Act of 1933 *regardless* of the person's lack of official status as an issuer, underwriter or dealer. *See Securities and Exchange Commission v. Chinese Consolidated Benevolent Association, Inc.*, 120 F.2d 738 (2d Cir.), *cert. denied*, 314 U.S. 618 (1941),[15]

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[14] By delivering LTV warrants to cover the naked short sales, without ever disclosing the intention to do so, Scattered also might be viewed as having sold an unregistered hybrid convertible security, in violation of § 12(1).

[15] In *Chinese Consolidated Benevolent Association*, a corporation organized for benevolent purposes which had actively encouraged the purchase of bonds issued by China violated the registration requirements of the 1933 Act, even though the corporation had no official or contractual relationship with the Chinese government, did not purchase and resell bonds to purchasers, nor receive any compensation from any person for these solicitation activities.

and *Securities and Exchange Commission v. Murphy*, 626 F.2d 633 (9th Cir. 1980).[16]

By contrast, the Seventh Circuit's narrow view of the reach of § 12(1) allows those who sell from an artificial and infinite supply of shares, such as Scattered, to escape liability. This frustrates the intention of the Act and its drafters. As adopted, the Section 4(1) exemption from liability (for "transactions by any person other than an issuer . . .") was meant to only exempt routine trading transactions, *Chinese Consolidated Benevolent Association, Inc.*, 120 F.2d 741 (2d Cir. 1941); Securities Act Release Number 5223, Adoption of Rule 144, 1972 Fed. Sec. L. Rep. (CCH) ¶ 78,487 (1972); it was not intended to exempt an enormous solicitation and distribution effort undertaken by investment professionals engaged in a massive short selling scheme.

CONCLUSION

For these various reasons, the petition for certiorari should be granted.

Respectfully submitted,

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[16] In *Murphy*, a corporate president who participated in sale-leaseback transactions with limited partnerships was not exempt from the registration requirements, even though neither the president nor the corporation sold or solicited the sale of any limited partnership interests or served as a general partner. In both cases the mere fact that the defendant was not technically an issuer, underwriter, or dealer, was insufficient, standing alone, to insulate the person from liability for violation of the registration requirements.

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APPENDICES

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 94-2015

SULLIVAN & LONG, INCORPORATED, *et al.*,
Plaintiffs-Appellants,

v.

SCATTERED CORPORATION,
Defendant-Appellee.

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division
Nos. 93 C 4069, 93 C 5346, 93 C 5447, 93 C 5740
Harry D. Leinenweber, *Judge*

ARGUED NOVEMBER 1, 1994—
DECIDED FEBRUARY 8, 1995

Before POSNER, *Chief Judge,* and COFFEY and MANION, *Circuit Judges.*

POSNER, *Chief Judge.* This is an appeal from the dismissal, for failure to state a claim, of a suit that charges violations of the securities laws growing out of a notorious, or at least newsworthy, episode of short selling of

common stock of LTV Corporation. *In re Scattered Corporation Securities Litigation,* 844 F. Supp. 416 (N.D. Ill. 1994); see, e.g., Kurt Eichenwald, "Stock Strategy under Scrutiny," *N.Y. Times,* Aug. 26, 1993, p. D1; Alexandra Peers & Jeffrey Taylor, "Chicago Broker Faces Inquiry over LTV Short Sales," *Wall St. J.,* Aug. 27, 1993, p. C1. The plaintiffs allege a "market manipulation" on an awesome scale that jeopardized the solvency of the Chicago (formerly Midwest) Stock Exchange. But like the district judge we have difficulty understanding what right of the plaintiffs the "manipulation" violated or how they were harmed.

LTV, a large steel producer, entered bankruptcy in 1986. In February of 1993 it announced a proposed plan of reorganization under which existing stock in the company would be replaced by new stock most of which would be issued to the bondholders and other creditors of LTV. Existing stockholders would receive warrants entitling them to purchase some of the new stock. The plan contained an estimate that the new shares would be worth only 3 or 4 cents. When the plan was announced, the old shares were trading for more than 30 cents. There were 122 million old shares outstanding.

The plan was confirmed by the bankruptcy court on May 27, 1993, and the court fixed June 29 as the last day on which the old shares would be tradable. Beginning before the confirmation date, but greatly accelerating on that date, the principal defendant, a Chicago Stock Exchange market maker (a dealer willing both to buy and sell a particular stock or other security for his account on a regular basis, 15 U.S.C. § 78c(a)(38)) with the alarming name of Scattered Corporation, sold short huge quantities of the old LTV shares. It sold short, in fact, tens of millions of such shares a week, for a total, when trading ended on June 29, of 170 million shares, far more than the 122 million old LTV shares outstanding. The excess of shares sold short over total shares outstanding is the focus of the plaintiffs' complaint.

A short sale is a sale at a price fixed now for delivery later. A trader sells stock short when he thinks the price of the stock is going to fall, so that when the time for delivery arrives he can buy it at a lower price and pocket the difference. If, for example, he sells the stock short at 50 cents a share, and the price falls to 40 cents before he delivers the stock, he can buy the stock for 40 cents a share, deliver it to the buyer, and have made a profit of 10 cents. Under the rules of the Chicago Stock Exchange, the buyer in a short-sale situation is entitled to delivery within five working days of the sale. If the seller fails to make delivery (maybe he doesn't have the stock), the rules entitle the buyer to "buy in" the stock, that is, to go out and purchase it on the open market and charge the price to the short seller. See *United States v. Naftalin*, 441 U.S. 768, 771 n.2 (1979). If in our example the price had risen by the end of five working days to 65 cents and the seller did not deliver, the buyer would go into the market, buy the stock at 65 cents, and charge the price back to the short seller. After the completion of the transaction, the buyer would have stock worth 65 cents that he had obtained at a net cost of 50 cents (50¢ + 65¢ — 65¢). Notice that a short seller's potential loss is unlimited, since it is simply the difference between the sale price and the market price—which could be anything.

The plaintiffs in this case were buyers on the other side of Scattered's short sales. They thought the price of the old shares would rise before plunging to 3 or 4 cents by June 29. (An old share would be worth that, rather than, as one might imagine, zero, because the holder of 100 shares was entitled to turn his shares in and receive 1.08 warrants to buy new shares at the rate of one warrant per share. The warrants, being worth approximately 100 times the old shares, were selling for between $3.125 and $4.125.) *Why* they thought this is a puzzle. Since on May 27 it was certain, or virtually so (nothing is *really* certain), that shares of common stock in LTV

would be worth no more than 4 cents in just a month, it is unclear why the stock did not plunge immediately to that level. In fact it remained in the two-digit range for quite some time, and on the very last day of trading was trading at 7.8 cents even though it was within hours of plunging to half that.

Scattered's counsel told us that the only reason the stock did not plunge immediately is that many brokers and investors do not read a plan of reorganization carefully—it is a long, complex, and jargon-ridden document —and hence many of them did not at first, or perhaps even at last, realize that the old stock in LTV would indeed be worth only 3 or 4 cents after the reorganization was completed. The problem may be endemic with reorganizations. Eichenwald's article suggests that many investors misunderstand the significance of news that a company is reorganizing. They see that the price of the stock is "low," and think that they are getting in on the ground floor rather than climbing aboard a sinking ship. See also Kurt Eichenwald "Being Nearly Worthless, Wang Shares, Of Course, Sell Briskly," *N.Y. Times*, Sept. 16, 1993, p. D8. Maybe the stock exchanges or the SEC should do something about these gullibles, since competition, which usually protects the uninformed purchaser, seems not to be working. Scattered, however, disclaims any legal responsibility for educating its buyers, and indeed has none, not being a fiduciary of the people it trades with. *Chiarella v. United States*, 445 U.S. 222, 233 (1980). Its counsel acknowledged that his client hoped to take advantage of these people by selling them stock short. That is what short sellers do: they bet on a declining market, trusting that they have better information or better instincts than other traders, those who will buy from them. There is nothing unlawful about trading on an information advantage, provided that it is not based on inside information, *id.* at 233, 235; *Dirks v. SEC*, 463 U.S. 646, 654-55 (1983); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495-96

(7th Cir. 1986), which is not alleged. Scattered merely had a better understanding of the information about the reorganization than the investors with whom it traded. It was not even a matter of its having nonpublic information, though the cases we have just cited make clear that trading on nonpublic information is lawful unless it is inside information. It was a matter of a superior interpretation of public information, the information contained in the plan of reorganization.

The effect of trading on an information advantage is to dispel, by penalizing, ignorance and to bring market values into closer, quicker conformity with economic reality. The profit that such trading brings at the expense of less knowledgeable traders provides the incentive for a private, for-profit firm, such as Scattered, to provide this economic service.

Darwinian this process may appear to be, and yet how many (if any) of the plaintiffs resemble the proverbial widow and orphan, or other harmless prey? Sullivan & Long is the first-listed plaintiff. According to a magazine article that the plaintiffs cited in their complaint, "Mr. Sullivan, who is a member of the CSE's [Chicago Stock Exchange's] board of governors and is an owner of CSE member firm Sullivan & Long Inc., tried to use an arbitration strategy similar to Scattered's to profit from the difference in price between LTV's stock and warrants. But in late June, Mr. Sullivan, who was effectively betting that LTV's stock price would decline, became concerned that the price might rise when he discovered how large a short position Scattered had. He bought LTV shares to cover his own short position, and his firm incurred modest losses. In July, Sullivan & Long filed suit against Scattered . . . ." Peter J.W. Elstrom, "Stock Probe Target Fights Back," *Crain's Chicago Business*, Aug. 30, 1993, pp. 3, 25. The article notes an allegation that Sullivan learned of Scattered's short position in his capacity as a governor of the Chicago Stock Exchange.

Scattered had no intention of delivering any of the LTV stock that it sold short. The last thing in the world that it wanted to do was to acquire and hold a stock that it believed certain to lose most of its value within weeks. Since it had no intention of buying any of the stock, it had no compunctions about selling short more LTV stock than existed. It ran the risk that the people on the other side of the short-sale transactions were right in betting that the price would rise before its terminal plunge, that those people would go into the market and buy stock when the price rose during the five-day period for delivery, and that they would force Scattered to reimburse them for these purchases, as in our hypothetical example of the stock sold short at 50 cents that rises to 65 cents. This risk—the risk that, if the *Crain's* article can be believed, Mr. Sullivan flinched at—did not materialize, because the price maintained its downward course. There were few buy-ins, and Scattered ended up making more than $25 million from its campaign of short selling. The plaintiffs claim that Scattered ignored such buy-in demands as were made upon it, but this is imprecise. Scattered refused to deliver old stock in response to such demands, but did offer warrants on new stock. The amount of old stock that it had sold short represented fewer than 2 million shares of new stock. This was only a small part of the total equity capitalization of the reorganized firm. The vast majority of the new stock was to go to the debtholders of the old firm. It would not have been infeasible for Scattered to buy enough warrants to satisfy all potential buy-in demands with new stock. It would have been infeasible for it to obtain enough old stock to satisfy all such demands in old stock.

We can understand, therefore, Sullivan's flinching. The risk was enormous, precisely because Scattered had sold short more old LTV stock than existed. If all the buyers decided to buy in, and if Scattered were deemed not entitled to pay these buyers with warrants rather than with old stock, the price of the old stock would skyrocket—

unless Scattered sopped up all this demand by continuing to sell short to these buyers. But at some point the buyers would worry about Scattered's ability to make good on all its promises to redeem its short sales. They would demand stock, not further promises to pay a high price if the stock rose in value. When this happened—this balking by the buyers—the plaintiffs would, until Scattered did go broke, be able to make money buying in the stock that Scattered had sold short to them. They say that Scattered prevented the price from rising (and thereby discouraged buy-ins by making them unprofitable) by selling short more and more stock. This is just to say that Scattered, like a bluffer in a poker game, kept redoubling its bet until the other players lost heart. But so what? Scattered's principals may be reckless gamblers, sharpies, wise guys, exploiters of loopholes, even violators of the letter or spirit of the rules of the Chicago Stock Exchange. Cf. *United States v. Naftalin, supra,* 441 U.S. at 776-77. We take no position on these questions, except to note that the Chicago Stock Exchange has forbidden the practice in which Scattered engaged—that is, selling short without having borrowed the stock being sold short or having equivalent guarantees of delivery. But it did this after the short-sale spree that is the basis of this suit, and anyway not every stock exchange rule confers a private right to sue. *Spicer v. Chicago Board of Options Exchange, Inc.,* 977 F.2d 255, 262-66 (7th Cir. 1992).

What troubles us most about this suit is the plaintiffs' failure to identify any harm to the objectives of the securities laws under which they have sued; for that matter they have failed to identify a rule that Scattered violated. The central objective, we take it, is to prevent practices that impair the function of stock markets in enabling people to buy and sell securities at prices that reflect undistorted (though not necessarily accurate) estimates of the underlying economic value of the securities traded. An efficient stock market is one in which stock prices reflect all potentially available information that is relevant

to the economic value of the stocks. Eugene Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work," 25 *J. Finance* 383 (1970). Not every practice that might reduce the efficiency of a stock market is prohibited; the securities laws compose a patchwork of rules rather than a seamless standard. But we would think twice before concluding that these laws prohibit "schemes" that accelerate rather than retard the convergence between the price of a stock and its underlying economic value and therefore promote rather than impair the ultimate goals of public regulation of the securities markets. Objectively, from May 27 on old shares of LTV stock were worth only 3 or 4 cents, and the defendant's campaign of short selling helped move the market price toward that true value. Had the plaintiffs succeeded in *their* scheme of reselling for, say, 50 cents stock that they had bought for 40 cents but that was worth only 4 cents, they would have been contributing to an irrational gyration in stock prices.

The plaintiffs call what Scattered did "market manipulation," a term that refers to tactics by which traders, like monopolists, create artificially high or low prices, prices that do not reflect the underlying conditions of supply and demand. *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 199. The only artificial prices, however, were the prices at which LTV stock sold between the confirmation of the plan and the expiration of the old stock. They were artificially high because they so greatly exceeded the stock's true value, which was only 3 to 4 cents. Far from launching a balloon, Scattered's short sales punctured a balloon, bringing prices down to earth where they belonged.

The name for what Scattered did is not market manipulation, but arbitrage. Arbitrageurs are traders who identify and eliminate disparities between price and value, or as in this case between today's price and tomorrow's price where the difference cannot be attributed to any prospective change in value. See *Falco v. Donner Foundation, Inc.,* 208 F.2d 600 (2d Cir. 1953). By doing this, ar-

bitrageurs promote the convergence of market and economic values that we suggested was the central objective of securities regulation. Consider a case in which the identical stock is selling for different prices on two exchanges at the same time. Since the value is the same, the prices should be the same. By buying stock on the exchange where the price is lower and reselling it on the other exchange, the arbitrageur brings about a convergence of price with value. This case is only a little subtler. The old LTV stock and the new stock that was to be issued when the plan of reorganization was implemented were not identical, but they were nearly so. The old stock was the stock until June 29, the new stock the stock thereafter. The two stocks were so far identical (putting aside the irrelevant difference in the roughly 100 to 1 rate at which old shares were convertible into new) that any difference in price between them was more likely to reflect a failure of the stock market to work properly than a difference in underlying conditions of demand and supply. Scattered played the arbitrageur's role in trying to equate the prices of these two nearly identical goods. Arbitrage is not market manipulation. The opposite of a practice that creates artifical prices, it eliminates artificial price differences.

The plaintiffs complain that the defendant prevented them from profiting from their purchases by flooding the market with successive waves of short sales, thus keeping the market price from fluctuating upward from time to time ("capping the price," they call it). Such upturns would have enabled them either to buy in at a higher price than the short-sale price and thus make a profit, if they had bought from Scattered, or to sell at a profit stock that they already owned. But "flooding" a market with short sales is not a rational formula for keeping price falling. On the other side of each such sale is a buyer who thinks the market price will rise. If he is right, the short seller will lose money, and the more shares he has sold short, the more money he will lose. As we have already

intimated, the short seller could sell so many shares short that his solvency was jeopardized. Suppose price rose and everyone who bought the shares sold short by Scattered tried to buy in. Since there would be more stock demanded than there was stock capable of being supplied, the price would soar and Scattered, which we are told was capitalized at only $1.5 million when the short selling began, would, unless it could redeem with warrants, soon go broke. But the plaintiffs are not complaining that if Scattered guessed wrong about the direction of the market, the price of the stock would rise *faster* than if Scattered had sold short fewer shares, for if that had happened the plaintiffs might have made money. And the threat of insolvency is one reason that buyers would have stopped accepting Scattered's offers to sell short, would instead have insisted on delivery or would have bought in and sought reimbursement from Scattered.

The plaintiffs analogize Scattered's plan to the scam in the movie *The Producers*. The "defendants" in that movie sold shares in a play to investors. They sold more than 100 percent of the shares, confident that the play—"Springtime for Hitler"—would be a flop, so that the investors would not ask for their share of the profits (there would be no profits). The play was a success, so the scam was exposed and they were sent to jail. Where the analogy fails is that while investors reasonably believe that the promoter will not sell more shares than exist, since he would then be defrauding the investors, a buyer of stock does not have a basis for equal confidence that the number of shares of a stock that is being sold short does not exceed the total number of shares in existence, since the seller is not trying to raise money for a venture. If even one share of a stock is sold short, there will be more shares actually or potentially for sale than there are shares in existence—since by definition the short seller does not own the share or shares that he is selling short—unless the short seller has borrowed stock in order to be able to

make delivery if the buyer wants delivery. Scattered was not the only short seller of LTV stock. Apparently the first-listed plaintiff in this case also sold LTV stock short. If Scattered had sold only 85 million shares short, and other arbitrageurs had sold in the aggregate another 85 million, the imbalance between shares for sale and shares in existence would have been identical, unless the arbitrageurs borrowed the stock they sold short.

Granted, it is customary for a short seller to borrow the stock that he sells short; if he did not, the buyers would lack confidence that he could deliver, and might worry that if they tried to buy in, the short seller would not have the money to reimburse them. But the plaintiffs do not point us to, and we have not been able on our own to find, a law that *requires* arbitrageurs or other short sellers to borrow the stock that they are selling short. So the plaintiffs could not count on the volume of short sales being capped at the total number of shares outstanding. They were on notice that the sort of thing that did happen might happen, if there were any trader as audacious as Scattered. Being on notice, they were not deceived.

It is true that in 1994—a year after the short selling of LTV's old shares—the Chicago Stock Exchange adopted a rule requiring a short seller to borrow the stock sold short or provide equivalent guarantees of being able to deliver. *Self-Regulatory Organizations: Chicago Stock Exchange, Inc.*, 59 Fed. Reg. 42082 (Aug. 16, 1994). But that is too late to help these plaintiffs. A further complication is that, as we have mentioned, Scattered did have, so far as appears, enough warrants to deliver *new* stock to cover any demands for old stock, though we do not know whether responding to such demands in this way would have satisfied the short-sales rules of the Chicago Stock Exchange or for that matter the contracts of short sale. Since there is not as yet any requirement of public disclosure of short sales (hence the allegation

that Mr. Sullivan abused his position as a governor of the Chicago Stock Exchange), see *Large Trader Reporting System*, 59 Fed. Reg. 7917 (Feb. 17, 1994); *Self-Regulatory Organizations: Notice of Filing of Proposed Rule Change by New York Stock Exchange, Inc.*, 60 Fed. Reg. 518 (Jan. 4, 1995), Scattered itself could not know the precise contribution that its short selling was making to the imbalance of which the plaintiffs complain.

We have thus far assumed that the short seller is not trying to deceive the market about what he is doing. The plaintiffs charge deception. They charge first of all that Scattered did not disclose that it had no intention of delivering any of the stock that it sold short. But if it was selling more shares than were outstanding, it could not deliver them—the requisite number of shares did not exist—so the plaintiffs' real complaint must be that Scattered did not disclose how many shares it was selling. But it was not required to disclose the number and the plaintiffs were not entitled to assume that Scattered would not sell more shares than were outstanding. Beginning on May 27, Scattered bought warrants so that it could deliver new shares to anyone who demanded delivery. The plaintiffs argue and we may assume for purposes of our decision that anyone who demanded delivery before June 29 would have been entitled to old shares. That individual's remedy, when Scattered refused to deliver old shares, would have been to buy them in. Apparently no one bothered to do that. No one who bought from Scattered is complaining that it was not able to buy in old shares, so that the *Brennan* case on which the plaintiffs rely is inapposite. *Brennan v. Midwestern United Life Ins. Co.*, 286 F. Supp. 702 (N.D. Ind. 1968), aff'd, 417 F.2d 147 (7th Cir. 1969). No matter how many tens or for that matter hundreds of millions of shares Scattered sold short, it could not extinguish any of the outstanding shares and thus it could not defeat the right of the buyers, including the plaintiffs in this case, to buy in the old shares and if the price was higher than the

price of the short sales to charge the price to Scattered and pocket the difference. And this is on the assumption that rule or contract required Scattered to deliver old shares, rather than warrants for new shares. If the latter form of compliance with the short-sale contract was permissible, the plaintiffs' case evaporates completely, since Scattered no longer would have been selling short more shares than existed.

The plaintiffs also complain that Scattered falsely marked its trading tickets "short exempt," meaning that Scattered was authorized to sell on down ticks in the market. (This means authorized to sell at a price equal to or below the last sale price, even if *that* price was equal to or below the next preceding sale price.) If Scattered was not exempt, it may have to answer to the Chicago Stock Exchange or the SEC, see SEC Rule 10a-1, but we do not see how its claim of exempt status could have deceived anyone in any respect that bears on this case. Exempt or not, a short sale is a short sale. If anything, the claim of exemption would lead investors to believe that Scattered was going to do *more* short selling than if it were not exempt, since exemption would free it from restrictions on short selling. And the plaintiffs' whole complaint is that they were fooled by the magnitude of the short selling that Scattered did.

Our analysis has shown that nothing alleged in the complaint is the kind of conduct that the securities laws are aimed at combatting. It is therefore not surprising that none of the plaintiffs' specific legal contentions has merit. They contend first and foremost that "by unprecedented massive short selling and by disguising the nature of their trades, the defendants controlled the price of LTV," in violation of section 9(a)(2) of the Securities Exchange Act of 1934. This section forbids "a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price

of such security, for the purpose of inducing the purchase or sale of such security by others." 15 U.S.C. § 78i(a)(2). As the plaintiffs themselves point out, the essence of the offense is creating "a false impression of supply or demand," for example through wash sales, where parties fictitiously trade the same shares back and forth at higher and higher prices to fool the market into thinking that there is a lot of buying interest in the stock. *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462, 476 (1977). There was nothing like that here. On the other side of all of Scattered's transactions were real buyers, betting against Scattered, however foolishly, that the price of LTV stock would rise. And Scattered made no representations, true or false, actual or implicit, concerning the number of shares that it would sell short. Maybe the plaintiffs' theory is that every short seller implicitly warrants that it won't sell short in such quantity as to jeopardize its financial solvency. This is an argument against short selling, or perhaps against short selling without borrowing the shares to be sold short—or perhaps against arbitrage. But other than in tender-offer situations, where short selling is prohibited, SEC Rule 14e-4 (formerly 10b-4; cf. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker,* 808 F.2d 930, 934 (2d Cir. 1986)), there is as yet no rule barring persons with a pronounced taste for risk from trading on stock exchanges.

Since there was no deception—no *relevant* deception, for as we have said Scattered's claim to be exempt could only magnify the impression that it was selling short far more shares than it could deliver, and thus tend to dispel the deception of which the plaintiffs complain—there is also no basis for a claim under Rule 10b-5, which requires proof of either deception or manipulation. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 114 S. Ct. 1439, 1448 (1994); *Basic, Inc. v. Levinson,* 485 U.S. 224, 239 n. 17 (1988); *Chiarella v. United States, supra,* 445 U.S. at 232; *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 199. Decep-

tion there was not; and most forms of "manipulation" involve deception in one form or another. *Santa Fe Industries, Inc. v. Green, supra,* 430 U.S. at 476-77. We have explained why no nondeceptive practice in which Scattered engaged was manipulative in the sense—the only possible relevant legal sense—of bringing about artificial prices for LTV stock.

As for the claim that Scattered violated section 12(1) of the Securities Act of 1933, 15 U.S.C. § 77*l*, by becoming an issuer of LTV stock without registering the offer or sale as required by that Act, this is quite fantastic. Only LTV could issue LTV stock, although persons controlling LTV, as well as (conventional) underwriters, could also be liable for selling unregistered stock, see 15 U.S.C. §§ 77b(11), 77d(1), 77e, 77*l*(1)—but Scattered was none of these. The remaining claims—violation of RICO, unjust enrichment, and violation of an Illinois consumer protection statute—are either makeweights or depend on contentions that we have already rejected. The complaint fails to state a claim and the suit was therefore properly dismissed.

It was properly dismissed for another reason as well. The plaintiffs could not prove injury with the degree of certainty, low that it is, necessary to obtain an award of damages in a securities case. *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975); *Pelletier v. Stuart-James Co.,* 863 F.2d 1550, 1557-58 (11th Cir. 1989). (They do not seek any other form of relief.) They bought stock that was selling for many times its actual value, hoping against hope that there were enough foolish investors to push the price up despite the imminence of its certain plunge. It is entirely speculative that but for Scattered's short selling, the plaintiffs would have sold at a profit or at a reduced loss before the price plunged to its value in the reorganization. The plaintiffs do not suggest that short selling in the stock of a firm undergoing reorganization is forbidden. Other traders might

have seen the opportunity Scattered did, and their short selling might have driven the price sufficiently low to thwart any profit by these plaintiffs. It was not necessary that short selling drive the price all the way down to 7.8 cents (where it was when the music stopped), only that it drive the price below what it would have been had Scattered not sold short in such massive quantities. But to recapitulate the essential point of this opinion, since the conduct in which Scattered engaged appears to have served rather than disserved the fundamental objectives of the securities laws, we are not inclined to strain to find a violation of a specific provision.

AFFIRMED.

A true Copy:

Teste:

Clerk of the United States Court of
Appeals for the Seventh Circuit

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

JUDGMENT—WITH ORAL ARGUMENT

Date: February 8, 1995
BEFORE: HONORABLE RICHARD A. POSNER, Chief Judge
HONORABLE JOHN L. COFFEY, Circuit Judge
HONORABLE DANIEL A. MANION, Circuit Judge

No. 94-2015

SULLIVAN & LONG, INCORPORATED,
JOSEPH D. LAPOTA, JR., MARK V. HARKINS, *et al.*,
Plaintiffs-Appellants

v.

SCATTERED CORPORATION,
an Illinois corporation,
Defendant-Appellee

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division
Nos. 93 C 4069, 93 C 5346, 93 C 5447 and 93 C 5740,
Harry D. Leinenweber, Judge

The judgment of the District Court is AFFIRMED, with costs, in accordance with the decision of this court entered on this date.

APPENDIX C

[Filed Jan. 20, 1994]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 93 C 4069
No. 93 C 5346
No. 93 C 5447

CONSOLIDATED CASES
JUDGE LEINENWEBER

IN RE: SCATTERED CORPORATION
SECURITIES LITIGATION

MEMORANDUM OPINION AND ORDER

FACTS

Defendant, Scattered Corporation ("Scattered"), is an Illinois corporation engaged in the business of buying and selling securities. During a period between February 26, 1993 and June 29, 1993, Scattered sold approximately 170 million shares of LTV Corporation stock ("old LTV shares" or "old LTV stock"). LTV was one of the nation's largest steel producers, and was embroiled in a long and complicated bankruptcy proceeding. On February 26, 1993, LTV announced a reorganization plan, which would allow the company to emerge from bankruptcy.

Under the plan, current shareholders would be given warrants granting the holder a right to receive "New LTV" stock ("new LTV stock") when, and if, issued. The new LTV stock would replace the old LTV stock, which would cease to exist. Holders of old LTV shares would receive approximately 1.08 warrants for each 100 shares of old LTV stock. This plan was approved by the bankruptcy court on May 27, 1993, and became effective on June 28, 1993. Sale of old LTV stock was halted on June 29, 1993.

Plaintiffs are persons and entities who bought LTV stock from Scattered between February 26, 1993 and June 29, 1993. During this period, plaintiffs allege Scattered sold approximately 170 million shares of LTV stock short. That is, Scattered sold Old LTV shares that it did not own or intend to borrow. Plaintiffs claim that Scattered sold enough stock short to create a false market, driving the price of LTV shares down. They allege that Scattered never intended to deliver the "old LTV" shares they sold. Rather, according to plaintiffs, Scattered intended to cover its sales in one of two ways. First, Scattered could delay issuing the shares until it received "new LTV" shares, which were worth a fraction of the price of "old LTV" shares. Alternatively, Scattered intended never to deliver anything, expecting the shares to be cancelled without further costs to clear.

Plaintiffs' complaint contains four theories of wrongdoing by Scattered. First, plaintiffs' state that Scattered's actions violated section 10(b) and Rule 10(b)(5) of the Securities Act of 1934. Second, Scattered allegedly sold unregistered stock, in violation of section 12(1) of the Securities Act of 1933 ("1933 Act"). Third, plaintiffs maintain that Scattered violated section 1964 of the Racketeer Influenced and Corruption Organization Act ("RICO"), 18 U.S.C. § 1961 et seq. (1993). Fourth, Scattered has allegedly been unjustly enriched by its criminal conduct.

Plaintiffs also seek to impose a constructive trust on defendants', CSX (f/k/a the Midwest Stock Exchange) and MCC, a wholly owned subsidiary of CSX. Plaintiffs claim that these parties currently possess around $5 million of Scattered's profits from the allegedly illegal trading.

Before the court are the following motions: (1) plaintiffs' motion for class certification, (2) Scattered's motion to dismiss, (3) defendants' CSX and MCC's motion to dismiss, (4) defendant motion to strike, (5) plaintiffs' interpleader motion, (6) Scattered's motion to dismiss the interpleader, and (7) plaintiffs' motion for a constructive trust.

The court grants plaintiffs' motion for class certification, reserving the right to create sub-classes in the future if necessary. It also grants defendants' motion to dismiss and gives plaintiffs 7 days to re-plead. In addition, the court finds that the other motions before the court are moot. The court offers the following rationale in support of its decision to grant Scattered's motion to dismiss.

DISCUSSION

I. Standard of Review for Motion to Dismiss

For the purpose of deciding defendant's motion to dismiss, the court assumes the truth of all well-pled factual allegations in the complaint and draws all possible inferences therefrom in favor of plaintiff. *Webster v. New Lenox School Dist. No. 122*, 917 F.2d 1004, 1005 (7th Cir. 1990). Dismissal is not warranted unless it appears beyond doubt that plaintiff could prove no set of facts that would entitle him to relief. *Caldwell v. City of Elwood*, 959 F.2d 670 (7th Cir. 1992).

II. Rule 10(b)(5)

A. Misleading Statements

In order to state a claim under Rule 10b-5, 17 C.F.R. § 240.10b-5,[1] the plaintiff must demonstrate that Scattered: (1) made an untrue statement of material fact or omitted a material fact that rendered the statements made misleading, (2) in connection with a securities transaction, (3) with the intent to mislead, and (4) which caused plaintiff's loss. *Schlifke v. Seafirst Corp.*, 866 F.2d 935 (7th Cir. 1989). The court in *Schlifke* also stated that the express language of Rule 10b-5 proscribes omissions that render affirmative statements misleading; thus, incomplete disclosures, or "half-truths," implicate a duty to disclose whatever additional information is necessary to rectify the misleading statements. *Id.* at 944. Even absent any misleading statements, an independent duty to disclose material facts may be triggered by a fiduciary relationship. *Id.*

In the present case, plaintiffs' well-pled allegations lead the court to the conclusion that it could not recover under Rule 10b-5. First, Scattered's inclusion of the words "short exempt" on their trade tickets did not violate Rule 10b-5. Under Rule 10b-5, to be actionable, a statement must, in fact, be misleading. *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17, 108 S. Ct. 978, 99 L.Ed.2d 194 (1988). Also, there must be a link be-

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[1] It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5.

tween the alleged misrepresentation and either the price received (or paid) by the plaintiff. *Id.* at 248-49.

Plaintiffs have failed to plead facts that would indicate that the statement was, in fact, misleading. Their complaint is devoid of facts that would indicate that the words "short exempt" played any role in their decision to purchase old LTV stock. Additionally, plaintiffs' complaint does not establish the essential link between the alleged misrepresentation and the price they paid for the old LTV stock. Since "short exempt" did not mislead plaintiffs, Scattered had no duty to disclose additional information concerning its trading activities. Nothing in the consolidated complaint would support a conclusion that the words "short exempt" affected the market for old LTV shares during the class period. Thus, the words could not have affected the price plaintiffs paid for the old LTV shares.

Furthermore, plaintiffs have failed to state facts that would establish the existence of a fiduciary relationship between plaintiffs and Scattered. Scattered, therefore, had no independent duty to disclose material facts to plaintiffs under Rule 10b-5.

B. Market Manipulation

Section 10(b) proscribes the use of "any manipulative or deceptive device or contrivance in contravention of the rules and regulations [of the SEC] employed in the purchase or sale of designated securities." Rule 10b-5, promulgated under this provision, details certain prohibited deceptive practices.

For Rule 10b-5 purposes, " 'manipulation' . . . refers generally to practices . . . that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus., Inc. v. Green,* 430 U.S. 462, 476 (1977). Injection of accurate information into the market price does constitute market manipulation. *In re Olympia Brewing Co. Securities Litigation,* 613 F. Supp. 1286,

1292 (N.D.Ill. 1985). According to the court in *In re Olympia,* short selling "is simply not unlawful, even in large numbers and even if the trading does negatively affect the price." *Id.* Also, "[w]here the trading volume and price simply reflect supply and demand based on accurate market information, this is lawful market behavior, not market manipulation." *Id.*

Sometime in February of 1993, the United States Bankruptcy Court for the Southern District of New York issued "The LTV Second Modified Joint Plan of Reorganization and Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code." The Plan and Disclosure Statement provided: "The estimated value of the consideration to be received by the holders of the Old LTV common stock would be approximately 3.22 cents." With this information, an efficient market would have driven the price of old LTV stock down during the period leading up to June 29, 1993, the date on which old LTV shares stopped trading.

Plaintiffs in the present case recognize that Scattered's short selling of stock, alone, was not unlawful. Plaintiffs also agree that the effect of Scattered's trading on the market was perfectly consistent with efficient market activity. That is, plaintiffs maintain that Scattered's short sales injected accurate information into the market, which drove the price of old LTV stock down. Thus, in light of plaintiffs factual allegations, and the reasonable implications therefrom, the court finds that plaintiffs would not be entitled to relief based on a theory that Scattered's activity artificially affected the market.

III. Sale of Unregistered Stock

Plaintiffs maintain that Scattered sold around 50 million more shares of old LTV than existed. In addition, plaintiffs claim that Scattered, according to its scheme, distributed LTV warrants in place of the old LTV shares it sold. Both of these acts, plaintiffs allege, constitute

the sale of unregistered stock in violation of section 12 (1) of the 1933 Act. 15 U.S.C. § 771(1) (1993). Plaintiffs further allege they are entitled to recover the consideration paid for the security with interest or damages under 15 U.S.C. § 771(2).

According to the 1933 Act, 15 U.S.C. § 77e:

> Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried through the mails or interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

However, section 77d of the 1933 Act states: "The provisions of § 77e of this title shall not apply to . . . transactions by any person other than an issuer, underwriter, or dealer." 15 U.S.C. § 77d(1) (1993).

With regards to the old LTV shares sold by defendants, the court finds that plaintiffs have proven no set of facts that would entitle them to relief. Specifically, plaintiffs have failed to provide the court with facts that would establish that Scattered was an "underwriter" of the old LTV shares. Therefore, pursuant to 15 U.S.C. § 77d, Scattered was not bound by the registration requirments of section 77e. Further, in light of the court's finding, the primary authority plaintiff's cite in support of their theory is distinguishable from the present circumstances. The defendant in *S.E.C. v. Graystone Nash, Inc.*, 820 F. Supp. 863 (D.N.J. 1993), was an underwriter of the stock in question and, therefore, subject to the registration requirements in section 77e.

The court also finds that plaintiffs cannot prove facts which would entitle them to relief based on their claim

that Scattered's sale of LTV warrants violated section 77e. The facts alleged by plaintiffs in their consolidated complaint maintain that, "Scattered defendants offered to and sold all 122 million . . . shares of *old LTV* common stock. . . ." Plaintiffs' Consolidated Complaint, ¶ 70; *see also* Plaintiffs Response to Defendant's Motion to Dismiss, at p.23 ("Scattered did not sell LTV warrants"). Plaintiffs allege, and Scattered agrees, that it sold *old LTV* shares, not LTV warrants. While the court notes that Scattered would have been in an extremely precarious situation if the LTV warrants were never issued, it cannot find that it sold unregistered LTV warrants when plaintiffs admit that Scattered sold old LTV shares. Furthermore, plaintiffs do not refute the fact that the LTV warrants, when issued on June 28, 1993, were exempt from registration under section 1145 of the Bankruptcy Code.

IV. RICO Claims

In Count IV of their consolidated complaint, plaintiffs claim that Scattered's short-selling scheme constitutes securities fraud and is a "racketeering activity" under 18 U.S.C. § 1961(1) (1993). Scattered's activity, according to plaintiffs, violated 18 U.S.C. § 1962(c), which provides:

> It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

However, the court has found that plaintiffs can prove no set of facts that would establish that Scattered's short-selling activity violated federal securities laws. Scattered's activities, therefore, do not constitute "racketeering activity" under 18 U.S.C. §§ 1961(1) or 1962(c). Plaintiffs have alleged no additional facts that would entitle them to relief under RICO.

V. Unjust Enrichment

To state a cause of action based on a theory of unjust enrichment, a plaintiff must allege that the defendant has unjustly retained a benefit to the plaintiff's detriment, and that defendant's retention of the benefit violates the fundamental principles of justice, equity, and good conscience. *HI Health Care v. Mt. Vernon Hosp.*, 131 Ill.2d 145, 137 Ill.Dec. 19, 26, 545 N.E.2d 672 (1989).

After a review of the well-plead factual allegations in the complaint, and drawing all possible inferences therefrom in favor of plaintiffs, the court finds that plaintiffs have not stated a claim that would entitle them to recover for unjust enrichment. More specifically, Scattered's retention of benefits would not violate the principles of justice, equity or good conscience. The well-plead facts indicate that Scattered took advantage of the information it possessed—information that was available to the public. Scattered took the risk that the LTV warrants would, in fact, be issued in the future. It exploited an inefficient market which did not accurately reflect the value of old LTV stock. Further, plaintiffs fail to state facts that would indicate that they would not have lost money if Scattered had issued the old LTV shares. In fact, plaintiffs do not even allege that they demanded their old LTV shares from Scattered during the class period.

VI. Constructive Trust

In order to impose a constructive trust under Illinois law, a court must find, "some form of wrongful or unconscionable conduct." *Chas. Hester Ent. v. Ill. Founders Ins. Co.*, 114 Ill.2d 278, 293 (1986). In the present case, the court finds that plaintiffs can prove no set of facts which would establish that Scattered engaged in wrongful or unconscionable conduct. Instead, the facts asserted by plaintiffs indicate that Scattered took advantage of the information it possessed and exploited the market's inability to accurately reflect the price of old

LTV stock. As a result of the court's finding, plaintiffs are not entitled to impose a constructive trust on Scattered's funds, which are held by defendants CSX and MCC.

VII. CONCLUSION

The court grants Scattered's motion to dismiss and gives plaintiffs 7 days to amend its complaint. The court points out that it is unclear from the facts pled when and how Scattered produced LTV warrants to cover the 170 million shares of old LTV stock it sold. Also, plaintiffs failed to provide sufficient facts to establish that Scattered unjustly benefitted to the detriment of plaintiffs in this case. Plaintiffs maintain that Scattered intended to produce something in return for the old LTV shares it sold: either old LTV shares or LTV warrants. In either scenario, Scattered's buying activity would have raised the price of the old LTV stock or warrants. The court is simply unpersuaded that plaintiffs have stated a claim absent evidence that plaintiffs requested, were denied, and would have sold their old LTV shares.

IT IS SO ORDERED.

/s/ Harry D. Leinenweber
HARRY D. LEINENWEBER
Judge
United States District Judge

DATED: 1/20/94

APPENDIX D

TRANSCRIPT OF DISTRICT COURT'S ORAL RULING

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93 C 4069

IN RE SCATTERED CORP. SECURITIES LITIGATION

ORAL RULING—March 29, 1994

This cause of action arises out of defendant Scattered Corporation's short-selling of stock in LTV Corporation. Plaintiffs are a class of persons who purchased LTV shares from defendant. In a previous ruling dated January 20, 1993, this court dismissed plaintiffs' complaint. Subsequently, plaintiff's filed an Amended Consolidated Complaint, which contains seven theories of wrongdoing by defendant: (1) Securities fraud under Rule 10b-5; (2) market manipulation; (3) sale of unregistered securities; (4) unjust enrichment; (5) violations of RICO; (6) violations of the Illinois Securities Act; and (7) violation of the Illinois Consumer Fraud and Deceptive Practices Act. Defendant moves to dismiss.

For the purpose of deciding defendant's motion to dismiss, the court assumes the truth of all well-pled factual allegations in the complaint and draws all possible inferences therefrom in favor of plaintiff. *Webster v. New Lenox School Dist. No. 122*, 917 F.2d 1004, 1005 (7th Cir. 1990). Dismissal is not warranted unless it appears beyond doubt that plaintiff could prove no set of facts that would entitle him to relief. *Caldwell v. City of Elwood*, 959 F.2d 670 (7th Cir. 1992).

In its amended complaint, plaintiffs again claim that defendant made misleading statements that constituted violations of Rule 10b-5. Plaintiffs offer two theories establishing a Rule 10b-5 violation. First, they allege that defendants never intended to produce the "Old LTV" shares they purported to sell. Second, plaintiffs maintain that they were misled by the "short exempt" language on the OLD LTV shares defendant sold.

The Seventh Circuit has stated that in the context of Rule 10b-5, it is insufficient for plaintiffs to allege the cause of their entering into a transaction in which they lost money, but not the cause of the transaction's turning out to be a losing one. *Bastian v. Petren Resources, Inc.*, 892 F.2d 680, 683-84 (7th Cir. 1990). Also, as this court previously stated, a Rule 10b-5 violation requires a link between the alleged misrepresentation and either the price received or paid by the plaintiff. *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

In the present case, the court finds that plaintiff has failed to allege the cause of the demise of Old LTV stock. Consistent with its prior ruling, the court further concludes that plaintiffs have failed to establish the essential link between the alleged misrepresentation and the price they paid for the Old LTV stock. First, plaintiffs' do not allege that they would have sold the Old LTV shares had defendant delivered them. In addition, the court dismisses plaintiffs contention that defendant's use of "short exempt" was the "but for" cause of their purchase of the stock. Plaintiffs admit that defendants short selling caused the price of Old LTV shares to decline. The court agrees with defendant that with or without defendant's actions, the price of Old LTV stock would have declined.

Thus, the facts in this case indicate that the but for cause for plaintiffs' losses on LTV shares was a bankruptcy reorganization plan, which drove the price of stock down. The plan would have had this result regard-

less of action by defendant. Thus, the court grants defendant's motion to dismiss plaintiffs' Rule 10b-5 claim since they have failed to plead sufficiently the causation element of the rule. The plaintiffs significantly do not allege that they were unaware of the impending bankruptcy reorganization or that defendant did anything to prevent them from learning about it.

The court also finds that plaintiffs' factual claims do not establish a claim for market manipulation under Rule 10(b) of the Securities Act of 1933 or Section 9(a)(2) of the Securities and Exchange Act of 1934. Both of these statutes require plaintiffs to plead facts establishing that defendant injected artificial or inaccurate information into the market. As this court has previously stated, however, defendant's trading did not artificially affect the market for Old LTV shares by injecting false information into the market. Nor did defendant's alleged violation of certain trading rules constitute a manipulation of the market. Instead, defendant's trading had precisely the same effect that an efficient market would have; defendant, by selling, caused the price of Old LTV stock to decline.

In their amended complaint, plaintiffs maintain that defendant issued an unregistered hybrid security in violation of Section 12(1) of the Securities Exchange Act of 1933, 15 U.S.C. § 771(2). The court disagrees. In addition, plaintiffs again have failed to plead facts establishing that defendant was an issuer, underwriter, or dealer under 15 U.S.C. § 77d(1). Therefore, as it did previously, the court finds that plaintiffs have failed to plead facts which would entitle them to relief under Section 12(1).

The factual basis for plaintiffs' unjust enrichment claim in their amended complaint is identical to that in the original complaint. It therefore fails on the same grounds. Plaintiffs still do not claim that they demanded their

Old LTV stock certificates. Further, the court has found that the effect of defendant's trading activity was no different than what could be expected in an efficiently operating market. Under these circumstances, the court finds that defendant's conduct did not violate fundamental principles of justice, equity, or good conscience.

In their response brief, plaintiffs urge the court to consider their wire fraud allegations as a basis for their RICO claim. The court has weighed the charges, but for the reasons stated in its previous ruling the court finds that plaintiffs have failed to plead a violation of RICO.

The court also finds that plaintiffs' claims under the Illinois Securities Act, 815 ILCS 5/12 (1993), must succumb to defendant's motion to dismiss for two reasons. First, the court has found that defendant did not violate Rule 10b-5. Second, the court has determined that defendant did not issue a hybrid security.

Finally, this court has found that the Illinois Consumer Fraud and Deceptive Business Practices Act applies to federally and state regulated securities transactions. *Horizon Federal Savings Bank v. Selden Fox & Assoc.*, 1988 WL 70473 (N.D. Ill. June 30, 1988). The court now agrees with its brother court that compliance with federal and state regulations is a defense to liability under the Act. *Wislow v. Wong*, 713 F. Supp. 1103, 1107 (N.D.Ill. 1989). Since plaintiffs have failed to plead a violation of federal or state regulations, the court dismisses its claim under the Illinois Consumer Fraud and Deceptive Business Practices Act.

In sum, the court now dismisses with prejudice plaintiffs' Amended Consolidated Class Complaint and Plaintiffs' Consolidated Class Complaint insofar as plaintiffs have attempted to incorporate it by reference. Defendant's Renewed Motion to Dismiss is granted.

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

March 13, 1995

Before Hon. RICHARD A. POSNER, Chief Judge
HON. JOHN L. COFFEY, Circuit Judge
HON. DANIEL A. MANION, Circuit Judge

No. 94-2015

SULLIVAN & LONG, INCORPORATED, *et al.*,
Plaintiffs-Appellants,

v.

SCATTERED CORPORATION,
Defendant-Appellee.

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division
Nos. 93 C 4069, 93 C 5346, 93 C 5447, 93 C 5740
Harry D. Leinenweber, *Judge*

ORDER

On February 22, 1995, plaintiffs-appellants filed a petition for rehearing with suggestion for rehearing en banc. All of the judges on the original panel have voted to deny the petition, and none of the active judges * has requested a vote on the suggestion for rehearing en banc. The petition is therefore DENIED.

*** Hon. Ilana Diamond Rovner did not participate in the consideration of the rehearing en banc.**

(2)

No. 94-2030

Supreme Court, U. S.
FILED
JUL 14 1995
CLERK

In The

Supreme Court of the United States

October Term, 1995

MARK V. HARKINS, SULLIVAN & LONG, INC., JOSEPH D. LAPOTA, JR., SAMUEL HOOKER, CHARLES HAWKER, CAROLE BLAND, AUDREY HEWITT, ANTHONY HEWITT, JOHN ECKENSTEN, RONALD J. MORAN, LESLEY RANNEY MORAN, TIMOTHY J. MORAN, LEON D. ARDELEAN, JEFFREY J. SIMS, SHEFFIELD WOLK, A.J. BLYTHE, DOROTHY B. NUSSDORF, DAN CHLIPALA, and JAMES HAMBURGER,

Petitioners,

v.

SCATTERED CORPORATION,

Respondent.

On Petition For A Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit

BRIEF IN OPPOSITION

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6 of 6

QUESTIONS PRESENTED FOR REVIEW

1. Do the securities laws prohibit as "manipulation" market conduct which does not mislead investors by artificially affecting market activity?

2. Can a market maker conducting an arbitrage consisting of selling one security which, by order of a United States Bankruptcy Court, will be canceled, while simultaneously buying the designated replacement security in sufficient quantity to fully hedge the total position be considered an "issuer" of the security sold for purposes of § 12(1) of the Securities Act of 1933, 15 U.S.C. § 77l(1)?

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED FOR REVIEW i

TABLE OF CONTENTS ii

TABLE OF AUTHORITIES iii

STATUTORY PROVISIONS INVOLVED 1

STATEMENT OF THE CASE 5

REASONS FOR DENYING THE WRIT 10

I. THE SEVENTH CIRCUIT CORRECTLY APPLIED THIS COURT'S WELL ACCEPTED TEST FOR MANIPULATION, FINDING NONE BECAUSE SCATTERED'S ALLEGED BEHAVIOR DID NOT CREATE OR MAINTAIN ARTIFICIAL PRICES 10

II. BECAUSE SCATTERED CANNOT BE DEEMED AN "ISSUER" UNDER ANY RATIONAL INTERPRETATION OF THE SECURITIES LAWS, IT CANNOT HAVE VIOLATED SECTION 12(1) OF THE 1933 ACT 20

CONCLUSION 25

TABLE OF AUTHORITIES

Page

CASES

Basic, Inc. v. Levinson, 485 U.S. 224 (1988) ... 14, 15, 17, 18

Boeing Co. v. Van Gemert, 444 U.S. 472 (1980) 20

Cammer v. Bloom, 711 F.Supp. 1264 (D.N.J. 1989) 14

Central Bank of Denver v. First Interstate Bank, ___ U.S. ___, 114 S.Ct. 1439 (1994) 13

Eckstein v. Balcor Film Investors, 8 F.3d 1121 (7th Cir. 1993) 13

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 11, 12, 13

Gustafson v. Alloyd Co., Inc., ___ U.S. ___, 115 S.Ct. 1061 (1995) 23, 25

Lipton v. Documation, Inc., 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985) 17

Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) 12, 13

Schlanger v. Four-Phase Systems, Inc., 555 F.Supp. 535 (S.D.N.Y. 1982) 15

Securities and Exchange Commission v. Murphy, 626 F.2d 633 (9th Cir. 1980) 23

Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (*en banc*), *cert. denied*, 459 U.S. 1102 (1983) 18

Sullivan & Long v. Scattered Corp., 47 F.3d 857 (7th Cir. 1995) ..... *passim*

Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959) 21

TABLE OF AUTHORITIES – Continued

Page

STATUTES AND RULES

11 U.S.C. § 1145 20

15 U.S.C. § 77b(4) 1, 21

15 U.S.C. § 77d 23

15 U.S.C. § 77l(2) 25

15 U.S.C. § 78i(a)(1) 2, 13

15 U.S.C. § 78j(b) 2, 13

17 C.F.R. 240.10a-1(c) 2, 9

17 C.F.R. 240.10a-1(d) 3, 9

17 C.F.R. 240.10a-1(e)(5) 3, 9

17 C.F.R. 240.10a-1(e)(7) 4

17 C.F.R. 240.10b-5 5

OTHER AUTHORITIES

F. Easterbrook, *Monopoly, Manipulation and the Regulation of Futures Markets*, 59 J.Bus. S103, S118 (1986) 15

Senate Report 1455, 73rd Cong., 2d Session 19

STATUTORY PROVISIONS INVOLVED

In addition to the statutory provisions cited by Petitioners, this Petition involves the following United States statutes and regulations:

1. 15 U.S.C. § 77b(4)

> (4) The term "issuer" means every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term "issuer" means the owner of any such right or of any interest in such right (whether whole or

fractional) who creates fractional interests therein for the purpose of public offering.

2. 15 U.S.C. § 78i(a)(1)

(a) It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange –

(1) For the purpose of creating a false or misleading appearance of activity trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security, . . .

3. 15 U.S.C. § 78j(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange –

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

4. 17 C.F.R. 240.10a-1(c)

(c) No broker or dealer shall, by the use of any facility of a national securities exchange, or

any means or instrumentality of interstate commerce, or of the mails, effect any sell order for a security registered on, or admitted to unlisted trading privileges on, a national securities exchange unless such order is marked either "long" or "short."

5. 17 C.F.R. 240.10a-1(d)

(d) No broker or dealer shall mark any order to sell a security registered on, or admitted to unlisted trading privileges on, a national securities exchange "long" unless (1) the security to be delivered after sale is carried in the account for which the sale is to be effected, or (2) such broker or dealer is informed that the seller owns the security ordered to be sold and, as soon as is possible without undue inconvenience or expense, will deliver the security owned to the account for which the sale is to be effected.

6. 17 C.F.R. 240.10a-1(e)(5)

(e) The Provisions of paragraph (a) and (b) of this section (and of any exchange rule adopted in accordance with paragraph (a) of this section) shall not apply to:

(5) Any sale of a security covered by paragraph (a) of this section (except a sale to a stabilizing bid complying with § 240.10b-7) by a registered specialist or registered exchange market maker for its own account on any exchange with which it is registered for such security, or by a third market maker for its own account over-the-counter,

(i) Effected at a price equal to or above the last sale, regular way,

reported for such security pursuant to an effective transaction reporting plan; or

(ii) Effected at a price equal to the most recent offer communicated for the security by such registered specialist, registered exchange market maker or third market maker to an exchange or a national securities association ("association") pursuant to § 240.11Ac1-1, if such offer, when communicated, was equal to or above the last sale, regular way, reported for such security pursuant to an effective transaction reporting plan; *Provided, however,* That any exchange, by rule, may prohibit its registered specialist and registered exchange market makers from availing themselves of the exemption afforded by this paragraph (e)(5) if that exchange determines that such action is necessary or appropriate in its market in the public interest or for the protection of investors;

7. 17 C.F.R. 240.10a-1(e)(7)

(e) The provisions of paragraph (a) and (b) of this section (and of any exchange rule adopted in accordance with paragraph (a) of this section) shall not apply to:

(7) Any sale of a security for a special arbitrage account by a person who then owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold; provided

such sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any such class of securities of the issuer;

8. 17 C.F.R. 240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(1) To employ any device, scheme, or artifice to defraud,

(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

Petitioners' Statement of the Case contains misstatements and omissions of fact which have a bearing on the

question of what issues would properly be before the Court if certiorari were granted. For this reason, Respondent submits this supplemental Statement of the Case to assist the Court.

Petitioners do not accurately describe the conversion mechanism by which the old common shares of LTV Corporation (hereinafter, respectively, the "Old Shares" and "LTV") were canceled and replaced with new LTV Series A Warrants (hereinafter, the "Warrants") as set forth in LTV's court-approved plan of reorganization in bankruptcy (hereinafter, together with the publicly distributed "Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code" (hereinafter the "Disclosure Statement") prepared by LTV, the "Plan").[1] Under the terms of the Plan, the Old Shares were to be canceled on or prior to the Effective Date.[2] Plan, § 3.14 at p. 8, Resp. App. at p. 25.

The Plan used a mathematical model called the "Black-Scholes Option Valuation Model" to determine the

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[1] Petitioners did not provide the Court with a copy of the relevant portions of the Disclosure Statement and Plan as confirmed by the bankruptcy court. We have provided the Court with these materials in Respondent's Appendix ("Resp. App.") submitted herewith.

[2] The Plan defines the "Effective Date" as the "second business day – (a) that is at least eleven days after the Confirmation Date; (b) on which no stay of the Confirmation Order with respect to the Joint Plan is in effect; and (c) on which all conditions in Article IX of the Joint Plan have occurred or been waived as provided in the Joint Plan." Plan, Ex. A, "Glossary of Defined Terms" at p. 6, Resp. App. at p. 29. The Plan was confirmed by the bankruptcy court on May 27, 1993. The Effective Date actually occurred on June 28, 1993.

precise number of fractional shares of the new LTV common stock being created by the Plan which each Warrant entitled its holder to purchase. Plan at p. 13, Resp. App. at p. 28. The Plan required the Black-Scholes formula to be applied such that the Warrants would, at all relevant times, have a specific fixed value:

> [The formula is to be applied:] in order to establish a $26.0 million valuation for the Series A Warrants (and a value per Series A Warrant of $3.059) . . .

Id. Because the holders of the Old Shares were entitled to receive approximately 1.08 Warrants for every 100 Old Shares held by them, the value of the Old Shares, assuming only confirmation and effectiveness of the Plan, was at all times approximately 3.3005¢ ($3.059 ÷ 100 x 1.08 = $0.033005). Disclosure Statement at pp. 56-57, Resp. App. at pp. 16-19. LTV clearly disclosed the new value of the Old Shares under the Plan to anyone who read that document:

> All existing publicly traded securities of the Debtors will be extinguished on the Effective Date. The only securities of the consolidated companies to be outstanding following confirmation of the Plans will be New LTV Common Stock, certain derivative equity securities (the Series A Warrants and SARs referred to below), the convertible preferred stock and $100 million of debt to be held by Sumitomo, and certain zero-coupon notes due in 2021 to be issued to the PBGC.
>
> * * *
>
> Holders of old LTV equity securities will receive exclusively Series A Warrants. The estimated

> value of the consideration to be received by the holders of the old LTV common stock would be approximately 3.31¢ per share . . .

Disclosure Statement, Summary, pp. 3, 5, Resp. App. at pp. 9, 14-15.

Petitioners also incorrectly describe Respondent Scattered Corporation's ("Scattered's") sales of Old Shares as short sales, intimating that they were naked short sales creating an unlimited supply of stock overhanging the market. As the Seventh Circuit correctly found, however, Scattered was conducting an arbitrage trading strategy. *Sullivan & Long v. Scattered Corporation*, 47 F.3d 857, 862 (7th Cir. 1995). Scattered purchased sufficient Warrants on the "if, as and when issued" market to cover its sales of Old Shares by later delivering the Warrants in satisfaction of the contracts by which the Old Shares were sold. Petitioners admitted as much when they alleged in their Amended Consolidated Class Complaint ("Am. Compl.") below that Scattered "created . . . a new 'hybrid' convertible security . . . consist[ing] of the sale of old LTV stock and the delivery of LTV warrants. . . . " Am. Compl. ¶¶ 84-85. Petitioners also admitted as much by dropping the breach of contract claim which was Count V of their original (pre-consolidation) complaint. Compl., Count V, *Sullivan & Long et al. v. Scattered Corporation, et al.*, Case Number 93 C 4069, filed July 7, 1993. Petitioners also admit in their Petition that "Scattered was able to evade delivery obligations until the shares had been converted to warrants." Petition ("Pet.") at p. 6. There is no question that the Seventh Circuit correctly found that Scattered's trading strategy was an arbitrage.

Petitioners also incorrectly describe the meaning of the "short-exempt" designation. Pet. at p. 6 n. 3. That designation has nothing whatsoever to do with delivery of shares sold short. The ticket marking requirements are set forth in SEC Rule 10a-1(c) and (d). Marking a ticket "short exempt" is a claim that the sale is subject to one of the exemptions from the normal short sale rule set forth in Rule 10a-1(e). In this case, Scattered's trades were subject to the (e)(5) and (e)(7) exemptions.[3]

There are no special delivery rules enabling anyone who marks a sale as "short exempt" to avoid regular delivery. If delivery is not made by the normal settlement date, the purchaser's broker may "buy-in" the undelivered securities, charging the seller with any losses if the price of the shares has risen in the interim. In fact, a number of Scattered's sales of Old Shares were "bought-in" after the settlement date but before Scattered delivered Warrants to settle those contracts.

Contrary to Petitioners' suggestions, there is no requirement that delivery of shares sold actually be made. Pet. at pp. 6-7. Although delivery is customary, the following observation by the Court below remains correct:

> [T]he plaintiffs do not point us to, and we have not been able on our own to find, a law that

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[3] Article VII, Rule 5 of the Chicago Stock Exchange, cited by Petitioners at page 6, note 3 of the Petition, is entitled "Termination of Rights by Suspension" and has nothing to do with these issues. *See* Chicago Stock Exchange Guide, ¶ 5 at p. 2053 (CCH, Inc. 1995).

> *requires* arbitrageurs or other short sellers to borrow the stock that they are selling short.

Sullivan & Long, supra 47 F.3d at 863. Petitioners cite in their Petition no rule requiring delivery. The "buy-in" procedures described above are the purchaser's sole remedy in the event of non-delivery.

Thus, no one was deceived, as petitioners suggest, by Scattered's alleged marking of trade tickets as short exempt. There was no claim below that anyone who actually wanted delivery of the Old Shares could not have obtained them, without damage arising from non-delivery, simply by buying Scattered in. Moreover, there were no allegations below as to how any purchaser of Old Shares could have been aware of (and thus deceived by) Scattered's alleged ticket marking prior to the time that they made their investment decision. The Seventh Circuit was correct in finding that no one was deceived by the alleged conduct. *Id.* at 864.

REASONS FOR DENYING THE WRIT

I. THE SEVENTH CIRCUIT CORRECTLY APPLIED THIS COURT'S WELL ACCEPTED TEST FOR MANIPULATION, FINDING NONE BECAUSE SCATTERED'S ALLEGED BEHAVIOR DID NOT CREATE OR MAINTAIN ARTIFICIAL PRICES.

As the Seventh Circuit correctly found, the conduct in which Scattered is alleged to have engaged simply does not constitute market manipulation:

> The plaintiffs call what Scattered did "market manipulation," a term that refers to tactics

> by which traders, like monopolists, create artificially high or low prices, prices that do not reflect the underlying conditions of supply and demand. *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 199. The only artificial prices, however, were the prices at which LTV stock sold between the confirmation of the plan and the expiration of the old stock. They were artificially high because they greatly exceeded the stock's true value, which was only 3 to 4 cents. Far from launching a balloon, Scattered's short sales punctured a balloon, bringing prices down to earth where they belonged.
>
> The name for what Scattered did is not market manipulation, but arbitrage. Arbitrageurs are traders who identify and eliminate disparities between price and value, or as in this case between today's price and tomorrow's price where the difference cannot be attributed to any prospective change in value.

Sullivan & Long v. Scattered Corp., 47 F.3d 857, 862 (7th Cir. 1995). Thus, Petitioners misconstrue the essential logic of the Seventh Circuit's decision. No "exception" was created for "good" manipulation. The Seventh Circuit, like the District Court before it, correctly applied this Court's well accepted test for manipulation, correctly finding no conduct alleged in any of the complaints filed below which satisfied that standard.[4]

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[4] Thus, contrary to Petitioners' suggestion, this case presents no issue of a conflict between the Circuit Courts of Appeal. The legal tests applied below have all been enunciated by this Court. The writ should be denied because the Seventh Circuit correctly applied these tests to the facts alleged in the complaints dismissed below. Moreover, a careful examination of the

As this Court has held, "manipulation" is "virtually a term of art when used in connection with securities markets." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976). The test for manipulation under the securities laws requires a showing of fraudulent or deceptive conduct. To prove manipulation, the plaintiff must show that the defendant intentionally engaged in conduct "artificially affecting market activity in order to mislead investors." *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477 (1977). No allegation of the complaints below, taken as true, is sufficient to show that Scattered engaged in any fraudulent or deceptive conduct of any nature or that Scattered artificially affected the market for Old Shares for the purpose of misleading investors. Without such linchpin allegations, the holding of the courts below that no manipulation was alleged is correct.

Petitioners suggest replacing this Court's well-accepted deception-based test for manipulation with a more simplistic test which merely requires a showing that the defendant "controlled" the price thereby damaging the plaintiff. *See* Pet. at p. 11 ("All market participants have a right to expect that prices are not being controlled, and therefore, the new exception announced below confounds the expectations of the investing public."). Petitioners' proposed test is unacceptable, however, for several reasons. First, it reaches far beyond the plain

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cases cited by Petitioners as being in conflict with the Seventh Circuit's decision in this case reveals that they also correctly applied the same tests to different factual situations. No reason to grant the Petition arises under such circumstances.

language of the statutes in question. Both §§ 9(a)[5] and 10(b)[6] of the Securities and Exchange Act of 1934, 15 U.S.C. §§ 78i(a) and 78j(b), clearly address only fraudulent or deceptive conduct, not conduct which merely causes a price change. This Court correctly continues to require close adherence to the text of the securities statutes in defining the limits of the conduct covered by them. *See, e.g., Central Bank of Denver v. First Interstate Bank*, ___ U.S. ___, ___, 114 S.Ct. 1439, 1447 (1994).

Petitioners' proposed manipulation test is also unworkable for as long as the efficient market hypothesis continues to be accepted by this Court. In an efficient market, every trade affects or "controls" the market to some degree and for some period of time. *Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1129 (7th Cir. 1993) ("The price in an open and developed market usually reflects all available information, because the price is an outcome of competition among knowledgeable investors."). The presence of many small buy orders for a stock at a particular bid price will clear out the sellers' offers at that price level and result in an increased bid price (as the buyers attempt to entice more sellers into the market) just as certainly as fewer, larger buy orders at the same bid

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[5] Section 9(a) addresses only conduct engaged in "[f]or the purpose of creating a false or misleading appearance of active trading . . . or a false or misleading appearance with respect to the market for any such security. . . . " 15 U.S.C. § 78i(a)(1).

[6] Section 10(b) addresses only conduct constituting a "manipulative or deceptive device or contrivance" which this Court has held to require a showing of fraudulent conduct. 15 U.S.C. § 78j(b); *Hochfelder, supra*, at 199; *Santa Fe, supra*, at 471-72.

price. Similarly, the absence of even small buy orders at a particular bid price will cause a stock's price support to fail at that level and the price to fall as sellers lower their asking prices in order to attract some buyers. Petitioners' test defining manipulation in terms of price control would literally render every successful trader a "manipulator" and erase any logical or predictable distinction between manipulative and non-manipulative conduct.

Contrary to Petitioners' claim, we suggest that market participants have no reasonable expectation that market prices are not controlled by market professionals. Market participants only have a reasonable expectation that the market has integrity. *Basic, Inc. v. Levinson*, 485 U.S. 224, 246-47 (1988). Put another way, market participants have a reasonable expectation only that the market professionals who control prices have acted honestly and that the resulting prices are not artificially affected by fraud or deceit.

The efficient market hypothesis (and the fraud on the market presumption upon which it is based) expressly relies upon the assumption that market prices are controlled by knowledgeable professional market makers and arbitrageurs. *See, e.g., Basic, Inc., supra*, 485 U.S. at 246 and n. 24 ("Congress expressly relied on the premise that securities markets are affected by information" and "we need only believe that market professionals generally consider most publicly announced material statements about companies, *thereby affecting stock prices.*" (Emphasis supplied)). These market professionals, of which Scattered is one, perform the essential function of forcing, by their trading, the price of stocks to reflect publicly available information. *See, e.g., Cammer v. Bloom*, 711 F.Supp.

1264, 1286-1287 (D.N.J. 1989) (citing the presence of control of a stock's price by market professionals as one indicator of an efficient market: "The existence of market makers and arbitrageurs would ensure completion of the market mechanism; these individuals would react swiftly to company news and reported financial results by buying or selling stock and driving it to a changed price level.").

Petitioners would disable this essential market mechanism, deeming every trade which "controlled" price to be manipulative market "rigging" regardless of whether the trade tended to add or remove artificial inflation or deflation from the price by driving the price towards or away from its underlying value as determined by the long-term forces of supply and demand. *See*, F. Easterbrook, *Monopoly, Manipulation and the Regulation of Futures Markets*, 59 J.Bus. S103, S118 (1986) (defining manipulation as trades which "do not move price more quickly in the direction that reflects long-run conditions of supply and demand."). The result would be utter chaos as market forces became disconnected from economic reality while market professionals (and others who recognized an inefficiency) were forced to stand idle on the sidelines for fear of facing manipulation charges arising from any trade which "controlled" the price (*i.e.*, literally any trade which moved the price against the plaintiff's position and resulted in a profit).

Were Petitioners' test the standard, the markets would truly become the "crooked crap game" previously derided by this Court in *Basic*. *See, Basic, Inc., supra*, 485 U.S. at 247 (quoting *Schlanger v. Four-Phase Systems, Inc.*, 555 F.Supp. 535, 538 (S.D.N.Y. 1982)). While Petitioners

quote this colorful comment in their petition, they fail to understand its true meaning. A "crooked crap game" existed in this case, but it was not Scattered's doing.[7] The "crooked crap game" existed because the public failed to realize that the Old Shares, which were trading in excess of $.30 when the Plan was confirmed on May 26, 1993, would shortly be canceled by operation of law and replaced with Warrants worth just 3.31¢[8] under the terms of the Plan.

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[7] During oral argument below, Chief Judge Posner asked us why the significant disparity existed between the market price and the value as established by the Plan. Although the reason is not evident from the record, we suspect that ill-informed members of the public who had failed to read or understand LTV's complete public disclosures were speculatively purchasing the Old Shares in the mistaken belief that they were purchasing an equity interest in the reorganized LTV Corporation. *See, Sullivan & Long, supra,* 47 F.3d at 860. At the time, the financial press was reporting LTV's pending successful emergence from bankruptcy and the company was running advertisements touting itself as the "New Strength in Steel." We also suspect that the modern trend towards discount stock brokerage (which effectively unbundles the purchase of trading services and investment advice) may have contributed to the number of uninformed investors. These trends are all the more reason why market professionals, like Scattered, must be permitted to act to protect the public by removing market inefficiencies as they arise.

[8] Petitioners' incorrectly fault the Seventh Circuit for accepting this value as fact. No evidentiary proof was required, both because of admissions in Petitioners' Amended Consolidated Class Complaint and because the courts below are entitled to consider the Plan and related public disclosure statements published by LTV. *Compare* Am. Compl. ¶ 21 *with* Pet. at p. 13.

A purchaser of the Old Shares during that time had the reasonable expectation that "the market price reflects as nearly as possible a just price" and that the markets operated "as indices of real value." *Basic, Inc., supra,* 485 U.S. at 246 (quoting *Lipton v. Documation, Inc.,* 734 F.2d 740, 748 (11th Cir. 1984), *cert. denied,* 469 U.S. 1132 (1985)). Clearly, during the time period in question, the market for the Old Shares neither operated as an index of the true value nor reflected a just or fair price for those shares. The uninformed members of the public who were purchasing the Old Shares were suffering immediate losses as a result. Scattered's alleged conduct operated to reduce those losses, not to cause them.[9] As the Seventh Circuit correctly found, Scattered acted to remove the artificial inflation in the price of the Old Shares:

> The effect of trading on an information advantage is to dispel, by penalizing, ignorance and to bring market values into closer, quicker conformity with economic reality. The profit which such trading brings at the expense of less knowledgeable traders provides the incentive for a private, for-profit firm, such as Scattered, to provide this economic service.

Sullivan & Long, supra, 47 F.3d at 860.

The facts of this case poignantly illustrate Justice White's fear of fraud on the market claims brought by a class of investors, who, through their own folly, have

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[9] Whatever Scattered did or failed to do, the Old Shares purchased or owned by everyone would be canceled and replaced with 3.31¢ worth of Warrants on the "Effective Date" defined in the Plan.

placed themselves in harm's way by failing to heed publicly available disclosures of material fact which, if read, would have fully protected them. *See, Basic, Inc., supra,* 485 U.S. at 258-59 (White, J. dissenting). Accepting Petitioners' removal of the fraud-deception requirement from the well-accepted test for manipulation would result in the imposition of liability against Scattered without fault and would truly turn the securities laws into "a scheme of investors insurance." *Id.*, 485 U.S. at 252 (quoting *Shores v. Sklar,* 647 F.2d 462, 469, n. 5 (5th Cir. 1981) (*en banc*), *cert. denied,* 459 U.S. 1102 (1983)). There is no basis in the legislative history of the securities laws or the express wording of the statutes to justify such a result.

The same analysis applies with equal force to Petitioners' § 9(a)(2) claims. There was no false or misleading appearance of trading or of supply or demand in this case. Every trade in which Scattered is alleged to have engaged was a real trade, possessing economic substance. Scattered is alleged to have sold Old Shares prior to their cancellation and to have purchased sufficient Warrants in order to arbitrage its position by being able to subsequently deliver the Warrants in settlement of the trades by which Old Shares were sold. There was nothing "artificial" about such a trading strategy. The public's demand for the Old Shares, albeit misguided, was nevertheless real, not artificial demand.

Nor can Scattered be said to have "artificially" enlarged the supply of Old Shares through its trading activities. The supply of LTV equity securities was irrevocably increased by LTV when it decided, as part of the

Plan, to issue the Warrants to replace the Old Shares.[10] Even if the focus is narrowed to just the Old Share leg of the arbitrage, short selling, as the Seventh Circuit correctly found, of even a single share, increases the supply of shares available to trade. *Sullivan & Long, supra,* 47 F.3d at 863. Accepting Petitioner's argument would effectively outlaw short selling. In passing the 1934 Act, Congress debated the merits of short selling, considering and rejecting an outright ban on the practice. *See* Senate Rep. 1455, 73rd Cong. 2d Sess. at pp. 50, 55 ("Short selling and the employment of stop loss orders have not been abolished by the act"). If that decision is to now be reversed, the argument to do so is better addressed to Congress than to this Court.

Through its alleged conduct, Scattered simply met (not induced) the public's real demand for Old Shares with real sales. The overall result, as found by the Court below, was to bring the market more under the control of

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[10] This case differs markedly from the scheme in the comedy movie "The Producers" in that Scattered is not alleged to have sold more shares than existed in economic reality. *See* Pet. at p. 6. n. 2. At all relevant times, LTV had created a vast supply of Warrants which were used, under the bankruptcy laws, to satisfy not only the claims of the former LTV equity holders, but also the claims of many creditors, as well. Thus, Scattered was able to arbitrage its sales of Old Shares by purchasing sufficient Warrants on the "when issued" market and delivering these Warrants in satisfaction of its contracts when LTV made the Warrants available to all of the former holders of the Old Shares. LTV's issuance of such Warrants was so vast that Scattered was able to sell more Old Shares than had been issued or outstanding while purchasing only a small fraction of the Warrants to cover these sales.

natural forces than it had been or would have continued to be without Scattered's alleged conduct. The result was not manipulation, as that term is defined for purposes of both §§ 10(b) and 9(a)(2).

II. BECAUSE SCATTERED CANNOT BE DEEMED AN "ISSUER" UNDER ANY RATIONAL INTERPRETATION OF THE SECURITIES LAWS, IT CANNOT HAVE VIOLATED SECTION 12(1) OF THE 1933 ACT.

Petitioners' § 12(1) argument is essentially that anyone who increases, by short selling, the supply of registered securities trading on a national securities exchange[11] must register the "new shares" thereby created. The Seventh Circuit properly found this argument to be "quite fantastic." *Sullivan & Long, supra,* 47 F.3d at 865. This Court should accord it no greater attention.

Petitioners' claim that Scattered has become an issuer of the Old Shares[12] by "exercising complete control over

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[11] At all relevant times, the Old Shares were listed and traded on the New York Stock Exchange and the Warrants were traded over the counter on a "when issued" basis.

[12] Petitioners have waived by failing to argue the point below, any claim that Scattered acted as an underwriter or dealer of the Old Shares or as an issuer, underwriter or dealer of the Warrants. *See, e.g., Boeing Co. v. Van Gemert,* 444 U.S. 472, 480 n. 5 (1980) (Refusing to consider an issue not perfected on appeal). The sale and distribution of the Warrants, securities created by a debtor in possession as part of a court approved plan of reorganization in bankruptcy, are exempt from regulation under the 1933 Act, being subject instead to a different regulatory scheme under the Bankruptcy Code. *See* 11 U.S.C.

the supply of that security" simply will not withstand scrutiny. Pet. at 15. LTV Corporation is the obvious issuer of both the Old Shares and the Warrants. LTV owned the business and assets in which the purchasers of those securities obtained an interest, it created both securities, it controlled the rights granted by those instruments to their holders and it offered them for initial sale or distribution. Only LTV, not Scattered, can be considered to be the issuer of these securities.

Generally, the "issuer" is understood to be the person owning the investment vehicle which represents the "common fund" necessary for a security to exist. *See, e.g., Woodward v. Wright*, 266 F.2d 108, 114 (10th Cir. 1959) (After finding fractional interests in oil and gas properties to be "securities" the court reasoned: "To be an 'issuer' of a security . . . the appellees must have been the owners of the oil and gas rights, and they must have created fractional interests therein for the purpose of public offering."). Petitioners rely upon the general definition of "issuer" set forth in § 2(4) of the Securities Act of 1933. 15 U.S.C. § 77b(4) (the "1933 Act"). This language, while broad, is insufficient to render Scattered an "issuer" because Scattered simply traded already issued and registered securities as part of an arbitrage, it did not "issue" or "propose to issue" them. The language of that same section proceeding to define "issuer" with respect to certificates of deposit, voting-trust certificates and the like

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§ 1145. Petitioners have never claimed that Scattered became an "underwriter" as to the Warrants, as defined under § 1145, by participating in a distribution of those securities through its sale of Old Shares. They may not do so now.

actually refutes Petitioners' argument, if the term "issuer" is to be construed consistently with respect to all forms of investment. With regard to an unincorporated investment entity not having a Board of Directors, Congress specifically provided that:

> [T]he term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued. . . .

Id. At all relevant times, LTV had a Board of Directors which exclusively performed all such functions. Scattered never managed, controlled or directed LTV or its business or property in any way.

While Petitioners suggest that persons other than issuers, underwriters or dealers have been found liable for selling unregistered securities, the only such persons who we have found are the "control persons" of the issuers, underwriters and dealers in question. Petitioners cite no cases holding liable someone other than an "issuer," "underwriter" or "dealer" or a "control person" of one. Scattered clearly was not a "control person" of LTV within the meaning of the 1933 Act.

Petitioners' argument is both totally unsupported by statute or case law and inconsistent with established practice. The public trading, regardless of volume, of securities which are already issued, subject to an effective registration statement, are listed and traded on a national securities exchange and are the subject of admittedly adequate and truthful public disclosures has always been

regarded as comprising "exempt transactions" under Section 4 of the 1933 Act. 15 U.S.C. § 77d. ("The provisions of section 5 shall not apply to – (1) transactions by any person other than an issuer, underwriter or dealer."). Although courts have warned of the need to narrowly construe exemptions from registration, the reason for such a construction is to effect the purpose of the 1933 Act:

> [E]xemptions from registration provisions are construed narrowly [citation omitted] in order to further the purpose of the Act: "To provide full and fair disclosure of the character of the securities, . . . and to prevent frauds in the sale thereof. . . . "

Securities and Exchange Commission v. Murphy, 626 F.2d 633, 641 (9th Cir. 1980) (Unlike this case, *Murphy*, like Petitioners' other cases, dealt with the sale of unregistered securities as to which full and fair disclosures of material facts were not available). There is no allegation here that full and fair disclosures as to the character of the Old Shares and the Warrants were not publicly available at all relevant times. The Seventh Circuit correctly found that no one had been deceived by Scattered's alleged conduct. *Sullivan & Long, supra*, 47 F.3d at 864.

As this Court recently held, the 1933 Act creates federal registration and disclosure duties primarily in connection with public offerings. *Gustafson v. Alloyd Co., Inc.*, ___ U.S. ___, ___, 115 S.Ct. 1061, 1068 (1995). Scattered conducted no public offering of either the Old

Shares or the Warrants.[13] It certainly did not create, issue or publicly offer any hybrid stock-warrant security, as Petitioners claim. The bankruptcy court, at the request of LTV, not Scattered, altered the rights of the holders of the Old Shares, created the rights of the holders of the Warrants and set the terms and schedule for the exchange of Warrants for Old Shares. The 1933 Act simply does not reach the short selling which Petitioners are attempting to use to attack.

Petitioners' theory of liability arises from an unduly strained construction of the statutory language which does nothing to further the essential disclosure-based purpose of the 1933 Act. Petitioners are attempting to use this misreading of the 1933 Act as an excuse to outlaw short selling, a step which Congress explicitly refused to take when it passed the 1934 Act. *See* Section I, *supra*. Were Petitioners' argument accepted, all short selling would become impractical because every short sale increases the supply of shares available for trading (thus meeting Petitioners' definition of an issuance of new securities) and only the corporation whose stock is being traded possesses sufficient access to material facts about the company necessary to prepare a complete and correct registration statement and prospectus.[14]

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[13] Indulging Petitioners in their fantasy momentarily, even if Scattered "issued" new Old Shares by selling more of them than existed, a registration statement was in effect and disclosures had been made as to those securities. There was no sale of unregistered securities violating § 5 of the 1933 Act.

[14] Were Petitioners' argument the law, arbitrageurs like Scattered attempting to meet the registration requirement in order to be permitted to reap a profit from returning economic

If short selling is to be declared illegal, then Congress ought to act in the first instance to make law. There is no reason for this Court to strain an attempt to find a prohibition against short selling within the present bounds of the 1933 Act.

CONCLUSION

Respondents respectfully request that the petition for a writ of *certiorari* be denied.

Respectfully submitted,

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efficiency to the market would be likely to make many innocent disclosure errors because they would lack the degree of access to the facts possessed by the corporation whose stock they were selling. In many cases, these arbitrage "issuers" would be able to escape liability for their misinformation by proving "that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." 15 U.S.C. § 77l(2). Such failed disclosure attempts, however, would serve only to confuse the market, not to assist investors, thus distracting from the purposes of the 1933 Act, which is concerned with providing investors with accurate and complete information, not with controlling arbitrage or short selling. *Gustafson, supra.*

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	)	In Proceedings For a Reorganization Under Chapter 11
CHATEAUGAY CORPORATION, REOMAR, INC., THE LTV CORPORATION, ET AL.,	)	Case Nos 86 B 11270 Through 86 B 11334 Inclusive, 86 B 11402, and 86 B 11464 (BRL)
Debtors.	)	

THE LTV SECOND MODIFIED DISCLOSURE STATEMENT PURSUANT TO SECTION 1125 OF THE BANKRUPTCY CODE AND JOINT PLAN OF REORGANIZATION

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Co-Counsel for the Debtors

February 26, 1993

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	)	In Proceedings For a Reorganization Under Chapter 11
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February 26, 1993

SECOND MODIFIED DISCLOSURE STATEMENT PURSUANT TO § 1125 OF THE BANKRUPTCY CODE

DISCLOSURE STATEMENT – SUMMARY

The LTV Corporation ("LTV") and sixty-six subsidiaries filed for Chapter 11 protection on July 17, 1986 or thereafter in the United States Bankruptcy Court for the Southern District of New York. With this disclosure statement these companies (the "Debtors") are filing a Joint Plan of Reorganization (constituting four separate Plans of Reorganization and one Plan of Liquidation) intended to bring these cases to a close and to permit the emergence of a strong, viable and competitive steel and energy concern.

History and Changes in the Business

These Chapter 11 cases have been among the longest and most complex bankruptcy proceedings ever filed, largely because of the complexity of the pre-filing corporate and financial structure of LTV, the magnitude of the total asserted claims and the difficult social, political and economic problems presented in resolving the legitimate and often conflicting interests of various creditor groups, governmental bodies, and retirees and employees of the Debtors.

LTV Steel Company, Inc. ("LTV Steel") itself represents the combination of three previously separate integrated steel companies – Jones & Laughlin, Republic and Youngstown Sheet and Tube – which were merged to rationalize their operations. As a result, LTV Steel became obligated with respect to extremely heavy retiree obligations. The struggle to address pension costs, which are

imposed on each of the Debtors as a result of the joint and several obligations under federal pension law, has been dealt with on many fronts, including intense litigation with the Pension Benefit Guaranty Corporation (the "PBGC"). Tentative resolution of these critical matters has been accomplished only after protracted and intense negotiations with the PBGC, creditor committees, other governmental bodies and union representatives.

The length of time required to resolve these complicated issues reflects the complexity of the enormous social and policy issues present in a bankruptcy where claims are asserted in the billions of dollars and the interests of hundreds of thousands of individuals in their diverse stakeholder roles are at issue. However, after years of effort, LTV is confident that it will have the needed participation and support of the essential parties to allow LTV and LTV Steel to move through the 1990's with assurance that a solution of substance and value has been achieved.

The PBGC agreement, execution of which is a condition to the effectiveness of the Joint Plan, is the keystone of LTV's reorganization of its financial obligations. The agreement (the "PBGC Settlement Agreement"), which is expected to be executed shortly, after completion of ancillary agreements, sets forth what LTV and the PBGC believe to be a realistic schedule for meeting LTV Steel's unfunded pension obligations by providing a unique thirty-year amortization schedule; allows LTV the financial flexibility it will need in the crucial first post-reorganization years; contains no requirement for the provision of collateral except in the event of a failure to meet fixed-payment obligations; and reflects concessions by the

PBGC of hundreds of millions of dollars which will both strengthen the pension plans and enhance LTV's viability. The agreement requires that LTV make an initial contribution of at least $850 million in cash and various other assets to the restored pension plans of LTV Steel, together with a portion of annual cash flow after capital expenditures until the pension plans are fully funded. LTV believes that this agreement, together with the restructuring of the other obligations of LTV Steel, will permit LTV Steel, the principal post-reorganization operating company, to be a viable competitive organization.

LTV Steel has been successful in restructuring other employee and retiree liabilities as well. By agreement with the United Steelworkers of America (the "USWA"). LTV Steel has implemented a defined contribution plan for its hourly employees and adopted a managed health care program for hourly employees and retirees. These actions are expected to yield substantial savings in the future while not diminishing the quality of medical services. Managed care programs have already been implemented for salaried employees and, pursuant to an agreement with a salaried retiree committee established by the Bankruptcy Court, will also be implemented with respect to salaried retirees. The post-reorganization union contract also provides for important productivity improvements that, in management's view, will yield substantial savings and position LTV Steel to operate more efficiently in today's increasingly competitive environment.

In addition to restructuring employment costs, LTV Steel has addressed other liabilities as well. For example, LTV Steel has terminated numerous major raw material

supply contracts and negotiated new and revised arrangements producing substantial cost savings and productivity improvements. LTV Steel has used the tenure of its bankruptcy to sell plant, property and equipment not necessary to its future operations and to demolish, clean up and dispose of numerous shutdown facilities. LTV has entered into a tentative global agreement resolving claims of the United States Environmental Protection Agency and expects to enter into parallel agreements with other environmental agencies and to enter into a comprehensive agreement with the Internal Revenue Service which will resolve hundreds of millions of dollars in excise tax claims and a myriad of other tax claims and tax treatment issues. Finally, LTV and LTV Steel have resolved thousands of lawsuits and claims stemming from their pre-confirmation activities and bankruptcy filings.

All of these steps will transform LTV from a company overwhelmed with debt into one with a manageable level of fixed payment obligations and a greatly simplified capital structure. The most significant obligations of the reorganized LTV are to fund the remaining legacy costs of LTV Steel, including pensions (pursuant to the PBGC Settlement Agreement) and retiree medical costs. At the LTV and LTV Steel levels, LTV has eliminated billions of dollars of debt (and balance sheet complexity and inflexibility) represented by the existence of many debt securities. The reorganized LTV will have no additional long-term obligations other than the investment by Sumitomo Metal Industries, Ltd. ("Sumitomo") referred to below and two zero coupon notes to the PBGC. To provide for adequate liquidity, LTV expects to have beginning cash

balances of $200 million and is arranging for the provision of working capital financing in the amount of $400 million (including support for outstanding letters of credit).

Because the national defense budget was shrinking and LTV expected that the defense industry would experience an extended period of consolidation, LTV concluded that the most effective way to maximize the value of its investment in LTV Aerospace and Defense Company and AM General Corporation was through a sale of the assets of these businesses. These sale efforts, with the auction process required by the Bankruptcy Code, resulted in very favorable prices for the assets of both companies.

On the steel business side, LTV Steel has sold its bar business, its Warren plant (other than the related coke producing facility), and its Drainage Products division, and used the breathing room provided by Chapter 11 to substantially improve its core facilities by investing approximately $2 billion in capital improvements. As a result of these substantial improvements, LTV Steel is today the second largest domestic producer of flat rolled steel products and is the largest domestic supplier of such products to the automotive and appliance industries.

Sumitomo has agreed to invest $200 million in LTV, through the purchase of convertible secured debt and convertible preferred stock. The Sumitomo investment will be made pursuant to an agreement (the "Sumitomo Agreement") which is expected to be executed shortly, after completion of ancillary agreements. LTV believes that Sumitomo's investment reflects a confidence in LTV

Steel which is fully warranted by LTV's new strength. LTV believes that this investment and relationship with Sumitomo, which has previously entered into two manufacturing joint ventures with LTV Steel, will provide LTV Steel with an important partner in the global steel market of the 1990's and beyond.

LTV anticipates that the restructuring of its finances and its businesses will provide substantial value to the equity of the new LTV. All of the general unsecured creditors of LTV, LTV Steel and LTV Energy Company will receive their recoveries principally in stock and creditors of LTV Aerospace and AM General will receive their recoveries partially in stock. Therefore, it is in the interests of all unsecured creditors, the future owners of the company, that LTV be strong and financially viable, and LTV's Joint Plan of Reorganization is designed with that objective.

For additional information as to LTV's projected financial performance, see "IV. Projected and Pro Forma Financial Information."

The Proposed Plans of Reorganization

The Plans of Reorganization govern five Groups of debtors, and, as required by the Bankruptcy Code, the creditors of each of the Groups – Parent, Steel, Aerospace, AM General and Energy – have been placed in classes based upon their status as secured, priority or unsecured and as senior or subordinated. A chart setting forth the classifications and the recoveries of each class may be found below in this Summary, under "Estimated Claims

and Recoveries by Class – Table of Estimated Recoveries". Creditors trying to determine where their claims are classified may wish to review the more extended discussion under "II. Plans of Reorganization", and particularly under subdivision "II. D. Summary Description of Classes and Their Treatment". Holders of publicly issued LTV debt securities should also review Exhibit B to the Joint Plan which sets forth the varying amounts of Allowed Claims applicable to the various issues of such debt securities.

In most cases, priority and secured claims will be paid in cash; unsecured claims will be paid in new LTV common stock (the "New LTV Common Stock"), except that at Aerospace and AM General some cash will be provided, and in all cases except Energy additional non-cash consideration will be distributed. Because a number of LTV's creditors, which exceed 125,000 in number, have very small claims, the Plans provide that, unless the holders elect otherwise prior to the Distribution Record Date, where a stock distribution would be less than 100 shares, the stock and related CVRs and Series A Warrants will be sold and the net cash proceeds distributed.

All existing publicly traded securities of the Debtors will be extinguished on the Effective Date. The only securities of the consolidated companies to be outstanding following confirmation of the Plans will be New LTV Common Stock, certain derivative equity securities (the Series A Warrants and SARs referred to below), the convertible preferred stock and $100 million of debt to be issued to Sumitomo, and certain zero-coupon notes due in 2020 to be issued to the PBGC.

LTV's financial advisors have estimated that the value of the New LTV Common Stock will be in the range of $1.1 billion to $1.3 billion. These estimates assume that the New LTV Common Stock is fully distributed and widely traded, that no conversions other than mandatory conversions have taken place and that any remaining negative effects of LTV's having been in bankruptcy have been dissipated. Giving effect to the shares to be issued pursuant to the Joint Plan, LTV estimates that there will be outstanding, by the first anniversary of the Effective Date, between 73 and 76 million shares (assuming conversion of the preferred stock and debt issued to Sumitomo), including the 50 million shares of New LTV Common Stock distributable to creditors. On the basis of these estimates and other relevant factors, LTV estimates that each share will have a value in the range of $15.42 to $19.11. These estimated values are based upon current information, including the LTV five year business plan, and financial market and economic factors as they currently exist. There can be no assurance that the stock will, in fact, trade in this range at the actual time of distribution to creditors or at any time thereafter.

Based upon an estimated value of the New LTV Common Stock of $17.26 per share (the midpoint of the estimated values), the overall recoveries by general unsecured creditors are estimated to be 17.7% for the Parent Group, 20.1% for the Steel Group, 55.8% for the Aerospace Group, 43.4% for the AM General Group, and 15.0% for the Energy Group, as such terms are defined in the Joint Plan. A table of Pro Forma holdings of New LTV Common Stock is set forth below in this Summary.

The Debtor Groups are arranged principally based upon historical operations, and it is a condition to confirmation that cases of affiliated companies within each Group be substantively consolidated. Other conditions for the confirmation or effectiveness of the Plan include approval and execution of the PBGC and IRS settlement agreements; execution of the working capital financing agreement; consummation of the Sumitomo transaction; a level of claims resolution sufficient to permit a substantial initial distribution to creditors upon consummation (with subsequent distributions thereafter); and the availability of $850 million (after giving credit for any amounts contributed to the pension plans during Chapter 11) for the initial cash contribution required by the PBGC Settlement Agreement, as well as the requirement, waivable by LTV, that, on the Effective Date, no member of the LTV Controlled Group shall be subject to the provisions of the Coal Industry Retiree Health Benefit Act of 1992.

In each of the Plans separate classes are provided for claims resolved by global settlement agreements, including the PBGC Agreement; an agreement with a trust created by the PBGC under Section 4049 of ERISA; the EPA and state environmental agreements; and the IRS agreement. In addition, separate classes are created for employee/retiree claims, for claims of recipients of workers' compensation and for partially secured claims of holders of J&L Mortgage debt. Intergroup claims are treated as general unsecured claims. Interests of holders of old LTV equity are treated separately and are to receive warrants for the purchase of New LTV Common Stock.

In order to preserve tax attributes, the Plans provide that the charter for the reorganized LTV will restrict the

ability to accumulate new equity in amounts over 4.5 per cent of outstanding equity (as determined in accordance with applicable tax principles) without the approval of the new Board of Directors, but contains no other trading restrictions. The Plans further provide for a process, developed by agreement with creditors, for choosing the new Board of Directors of LTV.

Each of the Plans provides for reorganization of the Debtor Group and discharge of all prepetition claims, except that the AM General Group, the assets of which have been sold, will be liquidated under Chapter 11. The assets of LTV Aerospace have also been sold but, pursuant to the sale agreement and related order of the Bankruptcy Court, LTV Aerospace must continue to hold preferred stock of the acquiror for a period of about five years after the acquisition, or 1997. The Plans provide that LTV Aerospace will be reorganized under Chapter 11 and merged with one or more of the direct or indirect subsidiaries of LTV (or LTV itself) as designated by LTV and approved by the Bankruptcy Court prior to the Effective Date, thus permitting LTV Aerospace to obtain a discharge under the Bankruptcy Code.

LTV is incorporated under the laws of Delaware, and recently moved its corporate headquarters to Cleveland, Ohio, from Dallas, Texas.

LTV believes that these Plans of Reorganization, with LTV's new business initiatives, represent the best way for LTV's creditors to maximize their recoveries. This has been a long, hard struggle, and any alternative route will inevitably result in years of additional litigation with

uncertain results. The Plans seek to preserve tax attributes by virtue of the allocation of recoveries, and these attributes would be jeopardized by any process other than a consensual confirmation process. In addition, a non-consensual process would jeopardize the Sumitomo investment and other elements of the Plans. In particular, any delay in the confirmation process beyond June 30, 1993 may jeopardize the PBGC, Sumitomo and USWA Agreements, with the result that the Restored Pension Plans could be reterminated. In that event, it may be anticipated that the PBGC would assert joint and several Claims in excess of $3 billion in every case; would assert that each of such Claims is entitled to administrative priority status; and, further, would engage in lengthy litigation to support its contentions. Therefore, LTV believes that creditors and equity securityholders should vote for the Plans.

Estimated Claims and Recoveries by Class

The estimated recoveries in respect of Claims in the event that all Voting Classes accept the Plans, based upon an estimate of the amount of the ultimately Allowed Claims, is summarized in the table on the following page.

The senior unimpaired Claims in each Group (Secured Claims, Priority and Administrative Claims) will receive their recoveries in cash. Certain other Claims are being satisfied through the execution and delivery of special agreements, including the PBGC Settlement Agreement, the IRS Settlement Agreement and the Environmental Settlement Agreement, or the making of special arrangements.

Holders of Allowed Claims in the other Impaired Classes in the Parent and Steel Groups will receive primarily, and in the Energy Group exclusively, shares of New LTV Common Stock.

Holders of Allowed Claims in the Steel Group will also receive Contingent Value Rights issued by the PBGC (or a trust established for such purpose) pursuant to a separate agreement between the PBGC and the Steel Creditors Committee.

Holders of Allowed Impaired Claims in the Parent Group will receive, in addition to shares of New LTV Common Stock, an aggregate of $21 million worth of Series A Warrants to purchase shares of New LTV Common Stock (based on the estimated trading value of the New LTV Common Stock on the six-month anniversary of the Effective Date, using the Black-Scholes Option Valuation Model with a volatility rate of 0.40).

In the Aerospace Group, holders of Allowed Claims in the other Impaired Classes will receive, in addition to shares of New LTV Common Stock, cash and a variety of other assets, including most of the non-cash consideration given by the purchaser of the assets of AM General and certain contingent rights in litigation in which LTV Aerospace is a plaintiff.

In the AM General Group, holders of Allowed Claims in the other Impaired Classes will receive cash in addition to shares of New LTV Common Stock.

Holders of old LTV equity securities will receive exclusively Series A Warrants. The estimated value of the consideration to be received by the holders of the old LTV

common stock would be approximately 3.31¢ per share and by the holders of the Old Preferred Stock approximately 42.99¢ per share of Class A Preferred Stock, approximately 5.73¢ per share of Class B Preferred Stock, approximately 21.49¢ per share of Class C Preferred Stock and approximately 5.38¢ per share of Class D Preferred Stock.

Plan recoveries are discussed in more detail under "II. Plans of Reorganization", and particularly under the subdivision "II.D. Summary Descriptions of Classes and Their Treatment".

Class Description	Description of Distribution Under the Plan
Class 6.60: Section 4049 Claims (Claims against the Parent Group with respect to liability under Section 4049 of Title IV of ERISA).	Claims in Class 6.60 will be satisfied by the execution and delivery of the settlement agreement with the 4049 Trustee and its implementation. This Class is unimpaired.
Class 7.10: Subordinated Unsecured Claims (Claims pursuant to debt issues that are contractually subordinated to the Claims included in Class 4.10, which may include the LTV 11% Subordinated Debentures due 2000; the LTV 7 1/2% Subordinated Debentures due 1993 and 1994; the LTV 1970 7 1/2% Subordinated Debentures due June 1, 1993 and June 1, 1994; the LTV Subordinated Exchangeable Variable Rate Notes Due August 15, 1995; the LTV 8 3/4% Subordinated Springing Reset Notes due June 1, 1998; the LTV 11 1/2% Subordinated Springing Reset Notes due March 15, 1997; the LTV 7 7/8% Subordinated Springing Reset Notes due April 1, 1998; the LTV 6 3/4% Subordinated Debentures due	Each holder of an Allowed Class 7.10 Claim will receive from or on behalf of the Debtors stock certificates evidencing such holder's Pro Rata share of the number of shares of New LTV Common Stock allocable to Class 7.10 in accordance with the "Distribution Provisions" described above, and such holder's Pro Rata share of the other Available Resources so allocable to such Class. It is estimated that each holder will receive 1.99 Series A Warrants and 4.77 shares of New LTV Common Stock per $1,000 of Allowed Claim. Exhibit B to the Joint Plan gives information as to the Allowed Claims under various public debt instruments. This Class is impaired.

April 1, 1994; the LTV 5% Subordinated Debentures due January 15, 1988; the LTV 6 1/2% Subordinated Debentures due September 15, 1988; and the LTV 11% Subordinated Debentures due July 15, 2007; and 11% Subordinated Debentures due July 15, 2007; and the Guaranties by LTV of the LTV International, N.V., 5% Guaranteed (Subordinated)Debentures due 1988, the LTV International, N.V., 10 1/4% Convertible Registered Notes due November 1, 1995 and the LTV International, N.V., 10 1/4% Convertible Bearer Notes due November 1, 1996).

Class 9.10: Old Preferred Stock Interests (approximately 7.2 million shares, including 205,500 shares of Series A Preferred Stock, 5,144,400 shares of Series B Preferred Stock, 289,400 shares of Series C Preferred Stock and 1,528,200 shares of Series D Preferred Stock).

Each holder of an Allowed Class 9.10 Interest will receive a certificate evidencing such holder's Pro Rata share of Series A Warrants valued at $527,500, representing approximately 14.05 Warrants (valued at approximately $42.99) per 100 shares of Series A Preferred Stock, approximately 1.87 Warrants (valued at approximately $5.73) per 100 shares of Series B Preferred Stock, approximately

	7.03 Warrants (valued at approximately $21.49) per 100 shares of Series C Preferred Stock and approximately 1.76 Warrants (valued at approximately $5.38) per 100 shares of Series D Preferred Stock. Distribution will be made on or about the Effective Date. This Class is impaired.
Class 10.10: Old Common Stock Interests (approximately 121.6 million shares), and any Claims for damages resulting from the prepetition purchase or sale of any securities issued by LTV ("Security Damage Claim").	The Equity Series A Warrants allocated to this Class (valued at $4,472,500) will be divided between Old Common Stock Interests and Damage Claimants in a ratio of 90% to 10% Each holder of an Old Common Stock Interest will receive a warrant certificate evidencing such holder's Pro Rata share of 90% of the Series A Warrants (valued at $4,025,250, representing approximately 1.08 Warrants (valued at approximately $3.31) per 100 shares of Old Common Stock) and each of the holders of Security Damage Claims will receive a certificate evidencing such holders Pro Rata share of 10% of the Series A Warrants (valued at $447,250),

	or the cash equivalent thereof after the sale by the Securities Claim Settlement Administrator. Distribution will be made on or about the Effective Date. This Class is impaired.
The Steel Group –	
Class 1.20: Secured Claims (fully secured Claims, including post-Filing Date interest to the Effective Date, and the secured portion of the partially secured Claims, without post-Filing Date interest. The fully secured Claims may include Claims offset by receivables (to the extent so offset); Claims secured by mechanics', possessory and other statutory or judicial liens; Claims secured by proceeds of Court-ordered sales of certain assets; the LTV Steel Mining Company 11 3/4% Term Note due August 15, 1986; the LTV Steel Mining Company Variable Rate Term Note due February 1, 1989; the LTV Steel Mining Company Variable Rate Term Note due February 1, 1993; the Youngstown Sheet and	Each holder of an Allowed Class 1.20 Claim will receive payment (a) in full in cash on or about the Effective Date, or the Debtors under this Plan will take other actions so that the Allowed Claim will not be impaired, or (b) as may be agreed upon by the holder of such Allowed Claim and such Debtors. Exhibit B to the Joint Plan gives information as to the Allowed Claims under various public debt instruments. This Class is unimpaired.

Tube Company First Mortgage Sinking Fund 4 1/2% Bonds, Series H, due October 1, 1990; the Youngstown Sheet and Tube Company First Mortgage Sinking Fund 4.60% Bonds, Series 1, due 1995; the Youngstown Sheet and Tube Company First Mortgage Sinking Fund 10 1/2% Bonds, Series J, due 2000; the Youngstown Sheet and Tube Company First Mortgage Sinking Fund 9 7/8% Bonds, Series K, due 1991; the Youngstown Sheet and Tube Company First Mortgage Sinking Fund 6 1/2% Bonds, Pollution Control Series A, due October 1, 1998 (and Related Debt – Ohio Air Quality Environmental Improvement Revenue Bonds, Series A); the Youngstown Sheet and Tube Company First Mortgage Sinking Fund 6 1/2% Bonds, Pollution Control Series B, due October 1, 1998 (and Related Debt – Ohio Water Development Authority Environmental Improvement Revenue Bonds, Series A); the Youngstown Sheet and

Tube Company First Mortgage Sinking Fund 6 ½% Bonds, Pollution Control Series C, due October 1, 1998 (and Related Debt – City of East Chicago Environmental Improvement Revenue Bonds, Series A); the Youngstown Sheet and Tube Company First Mortgage Sinking Fund Bonds, Pollution Control Series D, due June 1, 2005 (and Related Debt – Ohio Air Quality Environmental Improvement Revenue Bonds, Series B); the Youngstown Sheet and Tube Company First Mortgage Sinking Fund Bonds.

EXHIBIT 1

THE LTV SECOND MODIFIED JOINT PLAN OF REORGANIZATION

The Debtors in the above-captioned proceedings propose the following modified Joint Plan of Reorganization:

ARTICLE I

DEFINITIONS

All capitalized terms used herein and not otherwise defined have the meanings assigned to them in Exhibit A annexed hereto and made a part hereof, unless the context clearly requires otherwise. As used in this Plan, all other terms defined in the Code shall have the meanings assigned to them in the Code, unless the context clearly requires otherwise. For the purposes of this Plan, there are five groups of Debtors ("Debtor Groups"): the "Parent Group", consisting of The LTV Corporation, Kentron Saudi Arabia, Inc., LSC Leasing, Inc., The LTV Corporation (Wyoming), LTV International, N.V., LTV Sales Finance Company, LTVUS, Corp. and LTV Education Systems, Inc.; the "Steel Group", consisting of LTV Steel Company, Inc., BCNR Mining Corporation, Bardale Coal Company, Barrel Corporation of West Virginia, Chateaugay Corporation, Crystalane, Inc., Crystalee Coal Company, Dearborn Leasing Company, Erie B Corporation, Erie Development Company, Erie I Corporation, LTV Steel Mining Co, (formerly Erie Mining Company), Georgia Tubing Corporation, Gulf States Steel Corporation, J.W. Storage Company of Ohio, Jalcite I, Inc., Jalcite II, Inc., Jalore Mining Company, Ltd., Jones & Laughlin

Environmental Properties, Inc., Jones & Laughlin Mining Company, Ltd., Jones & Laughlin Ore Mining Company, LTV Electro-Galvanizing, Inc., LTV Holdings, Inc., LTV Leasing, Inc., LTV Steel Tubular Products Company, Lorain Pellet Terminal Co., Lykes Equipment Corporation, Lykes Leasing Corporation, Nemacolin Mines Corporation, Reomar, Inc., RepSteel Overseas Finance N.V., Republic Buildings Corporation, Republic Drainage Products Company, Republic Technology Corporation, Republic-Reserve, Inc., Tuscaloosa Energy Corporation, YST Erie Corporation and Youngstown Erie Corporation; the "Aerospace Group", consisting of LTV Aerospace and Defense Company, National Telephone Systems, Inc., Sierra Information Systems Corp., Sierra Research International Corp., Universal Time/Frequency, Inc., LTV Industries, Inc. (formerly Vought Industries, Inc.), LTV Multinational, Inc. (formerly Vought International, Inc.) and Vought Overseas, Ltd.; the "AM General Group", consisting of LTV Vehicle Corporation (formerly AM General Corporation). Amland Corporation and Vought Properties, Inc.; and the "Energy Group", consisting of LTV Energy Products Company, Continental Emsco Company, FC Divestiture Corporation, Halcorp, Inc., J.K. Industries, Inc., Juddcorp, Inc., LTV Properties, Inc., Oil States Offshore Marine, Inc., Oil States Rubber Co. and Technical Plastics, Inc.

ARTICLE II

Classification of Claims and Interests

For purposes of this Plan, Claims and Interests are classified as follows:

2.1 *Class 1.10 Claims.* Class 1.10 Claims shall consist of fully secured Claims against the Parent Group, including post-Filing Date interest to the Effective Date to the extent allowable under Section 506(b) of the Code (without any interest attributable to default or penalty rates, which shall be deemed cancelled, unenforceable and discharged), and the secured portion of partially secured Claims against the Parent Group, without post-Filing Date interest. The Class 1.10 Claims include the secured portion, if any, of the guaranty by LTV of the obligations of LTV Aerospace under the LTV Aerospace Term Loan Agreement.

* * *

their implementation; provided, that, if no Environmental Settlement Agreement has been entered into on or prior to the Effective Date with respect to any such Claim, such Claim shall constitute a Class 5.10, 5.20, 5.32, 5,40 or 5.50 Claim, as the case may be, and each holder of an Allowed Claim in such Class shall be entitled to a distribution equivalent to that provided for Allowed Claims with respect to such Class.

3.11 *Class 6.60, 6.70, 6.80, 6.90 and 6.95 Claims are not impaired.* Claims in Classes 6.60, 6.70, 6.80, 6.90 and 6.95 will be settled by the execution and delivery of the settlement agreement with the Section 4049 Trustee and its implementation.

3.12 *Class 7.10, 7.20, 7.30 and 8.20 Claims are impaired.* Upon satisfaction of the conditions set forth in paragraph 7.3 hereof and, to the extent applicable, in paragraph 7.4 hereof, each holder of an Allowed Class 7.10, 7.20, 7.30 or 8.20 Claim will be entitled to receive

certificates evidencing such holder's Pro Rata share of the number of shares of New LTV Common Stock allocable to Class 7.10, 7.20, 7.30 or 8.20, as the case may be, in accordance with Article IV hereof, and such holder's Pro Rata share of the other Available Resources so allocable to such Class in accordance with Article IV hereof.

3.13 *Class 9.10 Interests are impaired.* Upon satisfaction of the conditions set forth in paragraph 7.2 hereof, the Old LTV Preferred Stock will be cancelled and, upon surrendering his or her shares, each holder thereof as of the Distribution Record Date will be entitled to receive on the Effective Date, or as soon thereafter as practicable, a certificate evidencing such holder's Pro Rata share of 10.55% of the Equity Series A Warrants.

3.14 *Class 10.10 Interests are impaired.* The Equity Series A Warrants allocated to this Class will be divided between Old Common Stock Interests and holders of Security Damage Claims in a ratio of 90% to 10%. Upon satisfaction of the conditions set forth in paragraph 7.2 hereof, the Old Common Stock will be cancelled and, upon surrendering his or her shares, each holder thereof as of the Distribution Record Date will be entitled to receive on the Effective Date, or as soon thereafter as practicable, a certificate evidencing such holder's respective Pro Rata share of 90% of 89.45% of the Equity Series A Warrants, and each of the holders of Security Damage Claims will be entitled to receive from the Securities Claim Settlement Administrator either a certificate evidencing such holder's respective Pro Rata share of 10% of 89.45% of the Equity Series A Warrants, or the cash equivalent thereof after sale of such 10% of 89.45% of the

Equity Series A Warrants by the Securities Claim Settlement Administrator.

3.15 *Class 10.30 Interests are not impaired.* The Interests of the holders of the capital stock of the Debtors in the Steel Group (other than the LTV Steel Preferred Stock issued pursuant to LTV Steel's Employee Investment Program) will not be affected by this Plan but will remain outstanding with no change in the ownership or characteristics thereof.

3.16 *Class 10.40 Interests are impaired.* All shares of the LTV Steel Preferred Stock issued pursuant to its Employee Investment Program will be converted into shares of New LTV Common Stock at a ratio based on the value of the LTV Steel Preferred Stock, as determined in accordance with applicable law prior to the Effective Date.

3.17 *Class 10.50 and 10.70 Interests are not impaired.* The Interests of the holders of the capital stock of the Debtors in the Aerospace Group and the Energy Group will not be affected by this Plan but will remain outstanding with no change in the ownership or characteristics thereof.

3.18 *Class 10.60 Interests are impaired.* The Interests of the holders of the capital stock of the Debtors in the AM General Group will be cancelled as of the Effective Date; provided, that, from and after the Effective Date, the Debtors in the AM General Group shall continue in existence for the limited purposes of (i) winding up their affairs; (ii) making the distribution provided for in this Plan; and (iii) liquidating or abandoning any remaining assets.

"Residual Cash" means an amount of cash or cash equivalents equal to the sum of (A) at least $450 million of the Aerospace-AM General Sale Net Proceeds, (B) the Sumitomo Proceeds and (C) the total amount of cash or cash equivalents shown on the Consolidated Balance Sheet as of the last day of the calendar month immediately preceding the Effective Date, reduced by the sum of (i) $200 million, (ii) the Initially Required Cash, including any cash payable with respect to the secured portion of Class 1.27 Claims, (iii) the Additional Required Cash, (iv) the Cash Equivalent to Tax Refund, to the extent shown on such Consolidated Balance Sheet, (v) the Gadsden Note Proceeds, to the extent shown on such Consolidated Balance Sheet, (vi) any Warrent Trust Funds or Bar Trust Funds, to the extent received prior to the last day of such calendar month and shown on such Consolidated Balance Sheet, (vii) the Bar Note and Warrant Funds, to the extent received prior to the last day of such calendar month and shown on such Consolidated Balance Sheet, (viii) any of the Antitrust Litigation Proceeds to the extent received prior to the last day of such calendar month and shown on such Consolidated Balance Sheet, and (ix) any of the Aerospace-AM General Sale Net Proceeds, Sumitomo Proceeds or PBGC Stock Purchase Proceeds, to the extent received prior to the last day of such calendar month and shown on such Consolidated Balance Sheet:

"SARs" means Stock Appreciation Rights issued by LTV pursuant to the PBGC Settlement Agreement entitling the PBGC to receive, on the first anniversary of the Effective Date, shares of the New LTV Common Stock having a market value on such anniversary (calculated as

the average of the reported closing market prices on the New York Stock Exchange, or if the New LTV Common Stock is not listed on such Exchange, in such other manner as shall be agreed to by LTV and the PBGC, on the twenty trading days immediately preceding such anniversary) equal to the amount by which the aggregate market value on such anniversary of the Covered Shares exceeds the aggregate value, on a fully distributed basis, of the Covered Shares on the Effective Date, as determined pursuant to the PBGC Settlement Agreement;

"Series A Warrants" means 8,500.00 Series A Warrants to purchase shares of New LTV Common Stock, each of which will expire on the fifth anniversary of the Effective Date, will have an exercise price based on 110% of the average of the closing prices of the New LTV Common Stock for the thirty trading days immediately preceding the six-month anniversary of the Effective Date and will be exercisable for a fractional share of New LTV Common Stock determined by applying the Black-Scholes Option Valuation Model on the six-month anniversary of the Effective Date, using a volatility of 0.40, in order to establish a $26.0 million valuation for the Series A Warrants (and a value per Series A Warrant of $3.059); Series A Warrants having a value of $21 million shall constitute "Creditor Series A Warrants" and Series A Warrants having a value of $5 million shall constitute "Equity Series A Warrants";

"Special Aerospace Assets" means the Ren Obligations, the McDonnell Cause of Action, and rights to receive the Initial Thomson Litigation Proceeds and the beneficial interest in the Ren Stock, and any proceeds from any of the foregoing:

"Special Aerospace Cash" means $52 million;

"Special AM General Cash" means $2.6 million;

"Special IRS Cash" means $3.5 million;

"Sumitomo Proceeds" means the proceeds received from Sumitomo Metal Industries, Ltd., pursuant to the Sumitomo Agreement, net of any portion thereof required to pay expenses under such Agreement or to defray other costs incidental to such receipt; and

"Warren Trust Funds" means any net funds received by any Debtor or the designee of any Debtor from the liquidation of or other realization on the Warren Trusts (it being understood that refunds previously received from annual revaluations of the initial deposit thereunder shall not constitute realization on the Warren Trusts); and "Warren Trusts" means the trust established pursuant to the Salaried Security Enhancement Trust Agreement dated November 2, 1990 by and between LTV Steel and Bank One Trust

* * *

Effective Date means the second business day –

(a) that is at least eleven days after the Confirmation Date;

(b) on which no stay of the Confirmation Order with respect to the Joint Plan is in effect; and

(c) on which all conditions in Article IX of the Joint Plan have occurred or been waived as provided in the Joint Plan.

EIP Trust Shares has the meaning given that expression in paragraph 4.1A of the Joint Plan.

Employee means, with respect to any Debtor Group, an employee of one of the Debtors in such Debtor Group.

Energy Group has the meaning given that expression in Article I of the Joint Plan.

Environmental Settlement Agreements has the meaning given that expression in paragraph 4.1A of the Joint Plan.

EPA has the meaning given that expression in paragraph 2.23 of the Joint Plan.

Equity Series A Warrants has the meaning given that expression in paragraph 4.1A of the Joint Plan.

Equity Committee means the "Official Committee of Equity Security Holders of the LTV Corporation, *et al.*" consisting of those Persons appointed in the Cases by orders of the United States Trustee for the Southern District of New York, as amended from time to time.

ERISA means the Employee Retirement Income Security Act of 1974, as amended.

Evaluated Disputed Claims has the meaning given that expression in paragraph 4.1A of the Joint Plan.

Excess Bar Trust Funds has the meaning given that expression in paragraph 4.1A of the Joint Plan.

Filing Date means July 17, 1986.

Final Order means (a) a judgment, order, ruling or other decree issued and entered by the Court or by any state or other federal court or other tribunal located in

one of the states, territories or possessions of the United States or the District of Columbia, which judgment, order or other decree (x) has not been reversed or stayed and as to which the time to appeal has expired and as to which no appeal or petition for review, rehearing or certiorari is pending or (y) with respect to which any appeal has been finally decided and no further appeal or petition for certiorari can be taken or granted; or (b) a stipulation or other agreement entered into which has the effect of any such judgment, order or other decree.

Former Employee means, with respect to any Debtor Group, a person who was formerly an Employee of one of the Debtors in such Debtor Group.

4049 Trustee means the Trustee appointed by the PBGC pursuant to section 4049 of ERISA.

Further Distributions has the meaning given that expression in paragraph 4.2D of the Joint Plan.

Further Subordination Amount has the meaning given that expression in paragraph 4.2D of the Joint Plan.

Gadsden Note Proceeds has the meaning given that expression in paragraph 4.1A of the Joint Plan.

Guaranties has the meaning given that expression in paragraph 13.5 of the Joint Plan.